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ABSTRACT

The 11th publication in a series of subject presentations in the field of administrative management for use by educators and businessmen who teach management courses is presented. These presentations are intended to be particularly useful to Distributive Education in the smaller community where library research facilities are limited and equipment for the production of visual aids is not readily available. The lecture is designed to be presented to the businessman in nontechnical language. The Lesson Plan is an outline of the material covered which may be used as a teaching guide. The Presentation may be used as written or modified to meet local needs and conditions. The Visual Aids are photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The Supply Department contains materials which may be reproduced locally for distribution to course participants. Cases in Point are short actual small-business management cases which may be used to augment the presentation and to develop discussion. The Incubator contains ideas for stimulating further thought and discussion by the participants. A bibliography and list of Small Business Administration field offices are included. (CK)

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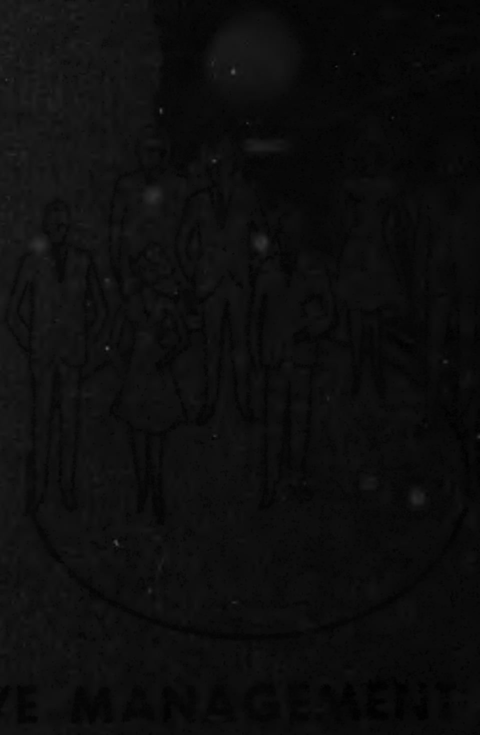
CHOOSING A FORM OF BUSINESS ORGANIZATION



ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic 11

SMALL BUSINESS ADMINISTRATION

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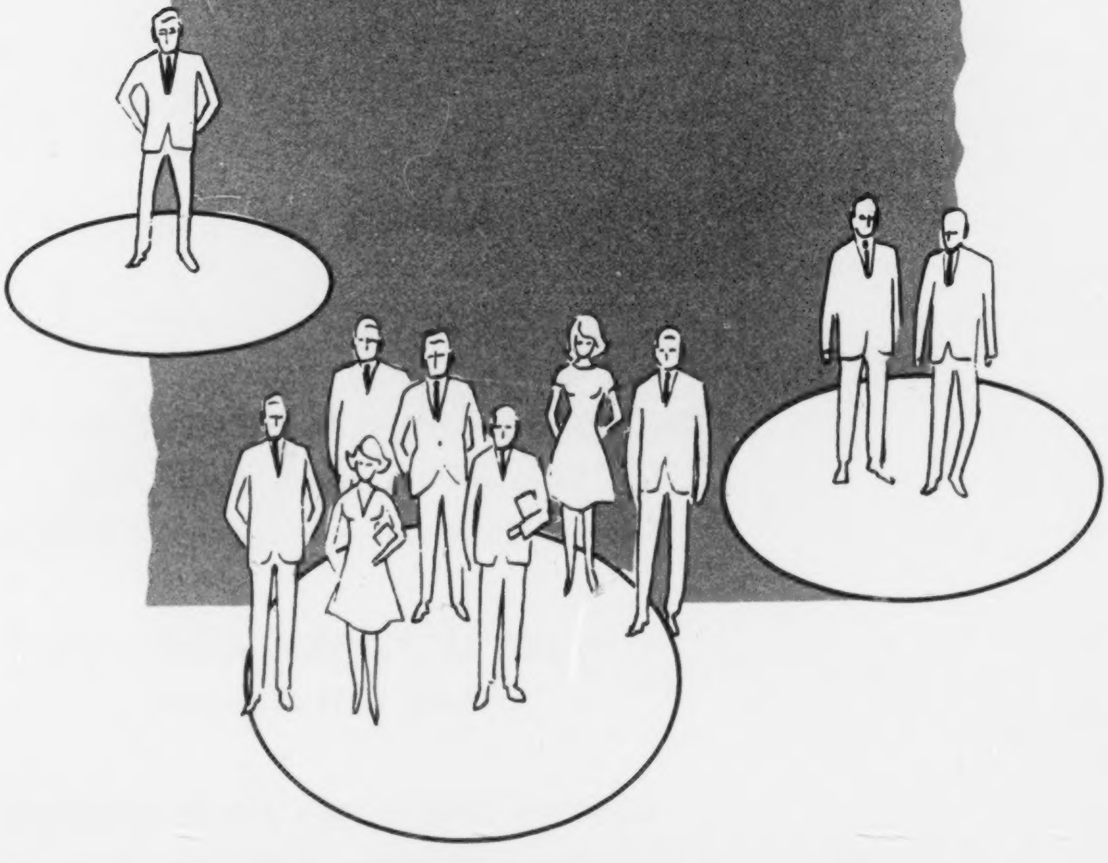
CHOOSING A FORM OF BUSINESS ORGANIZATION



ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic ⑪

Small Business Administration

Washington, D.C. 20416 1965

SMALL BUSINESS ADMINISTRATION

PROCUREMENT AND MANAGEMENT ASSISTANCE

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FOREWORD

The Administrative Management Course Program was developed by the Small Business Administration in cooperation with educational institutions to bring modern management knowledge and techniques to the owners and managers of small businesses. Within 10 years nearly 900 universities, colleges, and local school systems have cosponsored almost 4,000 courses with this agency. Over 110,000 owners and managers of small businesses have attended these courses. Distributive Education, working through the local school systems, has accounted for about one-third of these totals.

This is an outstanding demonstration of public spirit and service on the part of these hundreds of educational institutions. Yet, there remain many thousands of small-business owners and managers who have never had the opportunity to attend an administrative management course.

A committee on management education, consisting of representatives of the Small Business Administration and the Distributive Education Division of the American Vocational Association, was formed to study ways of meeting the small-business management needs of the small communities and very small businesses in poverty areas. The committee recommended that a series of subject presentations, including lesson plans, lectures, visual aids, case studies, and handout material, be developed to assist in the establishment of administrative management course programs in new locations. Further, it was felt that this material could substantially assist existing management programs, particularly by emphasizing the importance of continuing education for small-business owners and managers, and by assisting the busy instructor with his preparation.

SBA accepted the responsibility for developing a series of subject presentations in the field of administrative management for use by educators and businessmen who teach these management courses. We believe that these presentations will be particularly useful to Distributive Education in the smaller community where library research facilities are limited and equipment for the production of visual aids is not readily available. It will also assist community planning groups in implementing the educational provisions of the Economic Opportunity Act of 1964.

The booklet was developed by the Courses and Conferences Division. I wish to express appreciation to the Richmond Public Schools System for granting leave of absence to John O. Perreault, who drafted the booklet. The final version was prepared by John M. Bennett under the administrative direction of George C. Willman, Jr., Acting Chief of the Division. Artwork for the cover was prepared by Michael J. Fontana of the Graphics and Design Branch, Office of Administrative Services.

Irving Maness
Deputy Administrator

OCTOBER 1965

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*A set of the visual aids is available from the nearest SBA office (see inside back cover). These visuals are 8- by 10-inch colored transparencies for use on overhead projectors.

**Among the materials prepared as "handouts" to participants are several SBA free publications. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

A WORD ABOUT THIS SESSION

This publication, one of a series, is directed toward teaching management skills to the small-business man. When the term "management" is used, it refers to administrative management functions rather than to purely operational features of business. The complete set of subject presentations may be obtained on loan from the nearest Small Business Administration field office (listed on the inside back cover). Single booklets or complete sets may be purchased from the Superintendent of Documents, Washington, D.C., 20402.

This topic, *Choosing a Form of Business Organization*, was prepared to aid in teaching one session of a basic course. It contains sufficient material for a 45- to 60-minute lecture which is usually followed by a discussion period. The management case on page 59 can be used to extend the session or to form the basis for a second session on the topic.

The lecture is designed to be presented to the businessman in nontechnical language. It is *one* approach to teaching organizational management. Instructors will probably prefer to modify or revise the lecture in order to use their personal background and experience in the subject area. They may also find it preferable to alter the topic to take account of the training or special needs of their class participants.

This topic may be handled by a lawyer, a management consultant, or another whose training, experience, and interest qualify him. *Guide for Part-Time Instructors, Distributive Education for Adults,* a publication of the U.S. Office of Education, may prove useful to local instructors.

The various sections of the publication are separated by divider sheets of different colors. On the following page, these colors are given and the contents of the sections are briefly described.

Gray—*The Lesson Plan.* An outline of the material covered which may be used as a teaching guide, or as a framework for developing an individualized presentation. The lesson plan contains two columns: the left-hand column is an outline of the presentation; the right is a step-by-step indication of procedure, including chalk-board suggestions, quotations, discussion points, and a keyed guide to the visual aids available.

Rust—*The Presentation.* A carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. It may also be used as a source of information by a person preparing his own lecture.

Buff—*The Visual Aids.* Photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The subject presentation and lesson plan are keyed to the visuals. A set of visuals for each subject in this series may be borrowed from the nearest SBA regional office.

Green—*The Supply Department.* Materials which may be reproduced locally for distribution to course participants. Your nearest SBA office can furnish information on current availability of SBA free publications, including titles published subsequent to this volume.

Yellow—*Cases in Point.* Short actual small-business management cases which may be used to augment the presentation and to develop discussion, or as the basis for a second session on the same topic.

Blue—*The Incubator.* Ideas for stimulating further thought and discussion by the participants. This material may be reproduced locally for distribution to course participants. "Assignments" are designed to aid in retention of the subject matter of the session.

NOTE: See back cover for index reference to the divider sheets.

THE LESSON PLAN

A Keeping on Target

Section

STIMULATE GROUP BY SERVING AN INSTRUCTIONAL COCKTAIL

RECIPE

Use The Three B's (Bubbles)

○ ***Base*** instruction on problems at learners level.

○ ***Blend*** instruction with job experience.

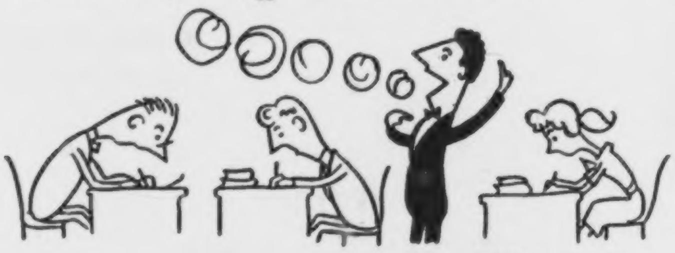
○ ***Brighten*** instructions with variety of ***illustrations, investigations*** and group ***participation***.

FOUR BASIC STEPS OF INSTRUCTION

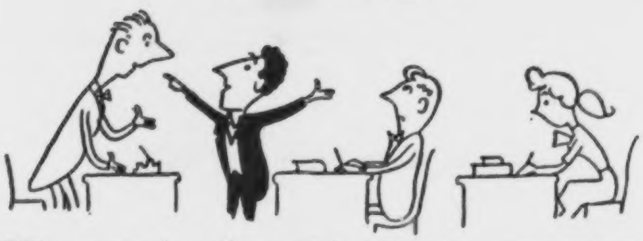
Instructing is like selling - -

Selling	Instructing
1. Approach customer	1. Prepare the group
Promptness	Start on schedule
Put at ease	Put group at ease
Awaken ***interest***	***Awaken*** interest
2. Present merchandise or service	2. Present information
Select merchandise to fit need	Gauge material to needs
Show one item at a time	Present one point at a time
Demonstrate ***selling points***	***Show, illustrate, question***
3. Have customer take part	3. Have group participate
Get merchandise into customer's hands	Get group to ***discuss***
Let customer "try on" merchandise	Have members ***demonstrate*** or ***use*** ideas
Answer questions and meet objections	Answer questions and correct errors
4. Bring sale to close	4. Bring meeting to a close
Help customers decide; ask:	Check on understanding; ask:
"which" "for whom" "when"	"why" "how" "when" "what" "where" "who"
Be sure merchandise fits need	Be sure group now can use information
Summarize points of care and use	Summarize "take away" ideas
Handle mechanics of sale	Make a definite conclusion
Pave way for return visit	Pave way for next session

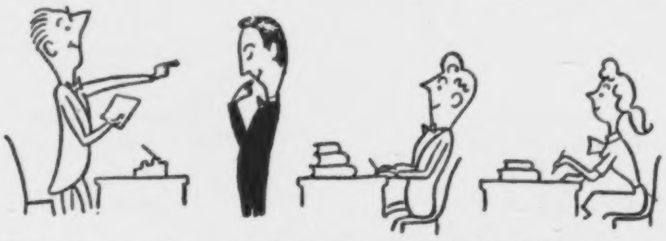
How To Deal With "Difficult Customers"



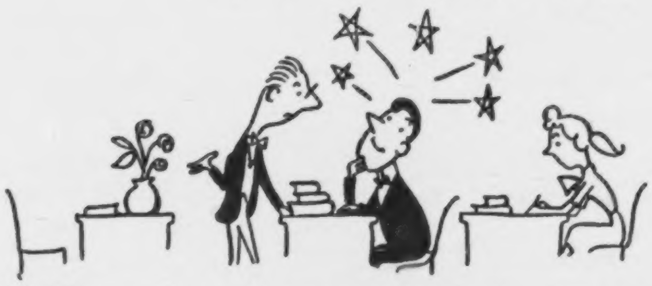
	What To Do
THE "MOUTH"—wants to do all the talking.	Take the play away from him by asking others to comment on his remarks. Deliberately turn to others and ask for their opinions. Avoid looking at him. Tactfully ask him to give someone else a chance, or talk to him in private.



THE "ARGUER"—constantly tries to catch you up.	Keep cool. You can never "win" an argument. Always make him back it up. Ask for evidence. Avoid getting personal. Refer the question to the group and then to him.



THE "MOUSE"—is in every group.	Call him by name and ask him for an opinion. Ask him an easy question he is sure to answer well, then praise him. This person is worthy of your attention.



THE "SO-WHATER"—is disinterested.	Point up something he has done as a good example of the point being stressed. Ask direct questions affecting his work.

LESSON PLAN

TOPIC: CHOOSING A FORM OF BUSINESS ORGANIZATION

OBJECTIVES:

To examine the various forms of business organization.

To call attention to the importance of a proper selection and cite the major financial and legal considerations.

To show the need for proper legal guidance in the selection process.

SESSION CONTENT	TIPS AND APPROACHES
I. DECIDING THE FORM OF A BUSINESS	
A. Important decision	Discuss.
B. Never final	
C. No one form best for all	
II. KINDS OF BUSINESS ORGANIZATIONS	
A. Common forms: 1. Sole proprietorship 2. Partnership 3. Corporation	Visual 11–1.
B. Uncommon forms: 1. Limited partnership 2. Statutory partnership association 3. Unincorporated association 4. Massachusetts or business trust 5. Close corporation 6. Subchapter S corporation	Stress use in individual situations.

III. INDIVIDUAL PROPRIETORSHIP

A. Advantages:

Visual 11–2.

1. Low start-up costs
2. Greatest freedom from regulation
3. Owner in direct control
4. Minimal working capital requirements
5. Tax advantage to small owner
6. All profits to owner

B. Disadvantages:

Visual 11–3.

1. Unlimited liability
2. Lack of continuity
3. Difficult to raise capital

IV. PARTNERSHIP

A. Advantages:

Visual 11–4.

1. Ease of formation
2. Low start-up costs
3. Additional sources of venture capital
4. Broader management base
5. Possible tax advantage
6. Limited outside regulation

B. Disadvantages:

Visual 11–5.

1. Unlimited liability
2. Lack of continuity
3. Divided authority
4. Difficulty in raising additional capital
5. Hard to find suitable partners

C. Partnership agreement (should include):

1. The type of business
2. Amount invested by each partner
3. Divisions of profit or loss

4. Compensations to each partner
5. Provisions for drawing by partner
6. Distribution of assets in event of dissolution
7. Duration of partnership
8. Provisions for dissolving
9. Provisions for withdrawals or admissions of additional partners
10. Dispute settlement
11. Restrictions on individual authority, especially in expenditures
12. Settlements in event of death or incapacity of one partner

D. Partnership dissolution:
   1. By agreement of partners
   2. By death
   3. By court action

E. Assets distributed:
   1. To outside creditors
   2. To partners
   3. To partners' investments
   4. To profits

V. CORPORATION

A. Corporation is a separate entity:
   1. May act as an individual
   2. Officers are apart from it

B. Advantages:
   1. Limited liability
   2. Specialized management
   3. Ownership transferable
   4. Continuous existence
   5. Legal entity
   6. Possible tax advantages
   7. Easier to raise capital

Visual 11–6.

C. Disadvantages: 1. Closely regulated 2. Most expensive form to organize 3. Charter restrictions 4. Extensive recordkeeping necessary 5. Double taxation	Visual 11–7.
VI. LIMITED PARTNERSHIP	
VII. PARTNERSHIP ASSOCIATION	
VIII. UNINCORPORATED ASSOCIATION (JOINT STOCK COMPANY)	
A. Variant of both partnership and corporation	
B. Associates do not have limited liability	
C. Has perpetual existence	
IX. MASSACHUSETTS OR BUSINESS TRUST	
A. Created by a deed of declaration of trust	Discuss.
B. Disadvantages: 1. Shaky legal foundation 2. Limited liability not allowed in some jurisdictions 3. Taxed as corporation	Stress that old "blue-sky laws" do not apply.
X. CLOSE CORPORATION	
A. Characteristics: 1. Special charter and bylaw clauses	Visual 11–8.

2. Long-term employment contracts
3. Shareholder's agreements
4. Irrevocable proxies and voting trusts
5. Restricted transferability of shares
6. Limited power for directors
7. Power of veto held by particular shareholders

B. Advantages:
   1. Limited liability
   2. Perpetual existence
   3. Tax advantages
   4. Tailored to closely held enterprises

XI. SUBCHAPTER S CORPORATION

Distribute Handout No. 11–1.

A. Authorized by Subchapter S of Internal Revenue Code (1958)

B. Separate entity of corporation disregarded for tax purposes

C. Avoids "double taxation" of corporate income without loss of corporate advantages

D. Requirements

XII. LIMITED LIABILITY: IS IT IMPORTANT?

A. Liability characteristics of the various forms of organization

Visual 11–9.

B. Use of insurance to protect against risks

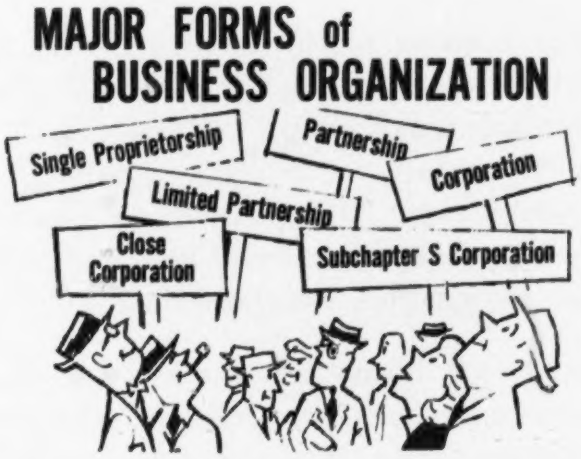
XIII. REMOVING PERSONAL ASSETS FROM CREDITORS' REACH	
A. Depends on various State laws	
B. Dangers involved	
XIV. CONTINUITY OF ENTERPRISE A FACTOR IN CHOICE OF FORM	
A. Single proprietorship	Visual 11–10.
B. Partnership	
C. Corporation	
D. Subchapter S corporation	
E. Others	
XV. USING DIFFERENT FORMS IN THE SAME ENTERPRISE	
A. For legal reasons	
B. For tax reasons	
C. For personal reasons	
XVI. "CUSTOM TAILORING" A FORM FOR YOUR NEED	
A. Designing an appropriate form	
B. Need for regular legal counsel	
XVII. A SPECIALIZED FORM OF BUSINESS ORGANIZATION—THE FRANCHISE SYSTEM	
A. Definition	Discuss.
B. Kinds	
C. Locating a franchise	Visual 11–11.
D. Advantages	Visual 11–12.
E. Disadvantages	

CHOOSING A FORM OF BUSINESS ORGANIZATION*

INTRODUCTION

One of the most important decisions that organizers of a small-business enterprise must make is whether to set up the business as a single proprietorship, as a partnership, as a corporation, or some other business form.

When a business form has been selected, the decision is never really final for most small businesses. At least it should not be final. Not only will your business grow and change in its needs and prospects, but your financial and tax situations will change and perhaps new owners will buy into the business. Furthermore, legal and tax developments may modify the characteristics and relative advantages of the various business forms. In view of such changes, you and your attorneys must reexamine from time to time the question of what business form is best adapted to the needs of the business and its owners.



Visual No. 11-1

By careful planning and drafting, a business form often can be tailored to give it the qualities deemed wanted in a particular enterprise. Thus the selection of a form of business organization is not confined to strictly defined forms but includes the traditional forms as they can be designed, by imaginative and skillful planning, to meet the needs of the particular business situation.

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* This text is an abridgment and adaptation of the Small Business Management Research Report "Choosing a Form of Business Organization," prepared for the Small Business Administration by the School of Law of Duke University.

No one form of business organization, or for that matter no combination of two or more of them, is suited to each and every small business. To attempt to state what is the best form for all enterprises would be like trying to select an all-purpose suit for a man, not a certain man but any man. In choosing a business form, consideration to the parties concerned must be made—their likes, dislikes and dispositions, their immediate and long-range needs and their tax situations. Also, the legal and tax status of each business form in the State or States involved must be thought about. Seldom if ever does any one factor completely determine the business form.

Before discussing their advantages and disadvantages, perhaps we should enumerate the different business forms and devote a few words to describing them and listing some of their main characteristics.

KINDS OF BUSINESS ORGANIZATIONS

Some of the forms of business organization available in this country are: (1) the single proprietorship (owned by one person), (2) the partnership, (3) the corporation, (4) the limited partnership, (5) the statutory partnership association, (6) unincorporated association, the most familiar example of which is the joint stock company, and (7) the Massachusetts or business trust. In addition, two modifications of the corporate form should be considered, namely, (8) the close corporation, and (9) the Subchapter S corporation.

The most commonly used business forms are the single proprietorship, the partnership, and the corporation (including the close corporation). Merely because these are the most common forms, however, you should not exclude the other organizations from consideration; one of them may prove to be the most serviceable in your particular business situation.

ADVANTAGES of the SINGLE PROPRIETORSHIP

1 Low start-up costs
2 Greatest freedom from regulation
3 Owner in direct control
4 Minimal working capital requirements
5 Tax advantage to small owner
6 All profits to owner

Visual No. 11-2

Single Proprietorship

The single proprietorship is the simplest form in which a business can be conducted. Because of its simplicity, it is the cheapest form to organize. The proprietor is the sole owner of the business and has complete control over it. This is true even though he cannot operate the business by himself but must hire employees to help him conduct it. Furthermore, as sole owner of the business, the proprietor is personally liable on business contracts and is responsible for torts (negligent acts and other offenses) committed by employees within the scope of the enterprise's activities.

DISADVANTAGES of the
SINGLE PROPRIETORSHIP

Unlimited liability
Lack of continuity
Difficult to raise capital

Visual No. 11-3

Partnership

A partnership contemplates conduct of a business by a number of persons who have the status and authority of owners or principals. The Uniform Partnership Act defines the partnership as "an association of two or more persons to carry on as co-owners a business for profit." The creation of a partnership ordinarily involves the contribution of the capital or foundation of the business—that is, property, money, skill, or labor—by the participants.

Most partnerships are evidenced by an agreement or contract among the co-owners. Without question, a carefully prepared written agreement spelling out the rights and duties of the partners is highly recommended. Nevertheless, a partnership can be created by several persons, simply conducting as co-owners a business for profit because a contract, written or oral, is not essential. In fact, the partnership relation may be imposed by law upon people who have no intention of becoming partners.

When partners do enter into a written agreement defining their relations and specifying how profits and losses are to be divided, it is a purely private document.

There is no requirement that such an agreement, called "articles of partnership," be filed with a public agency. The parties to the agreement are free to include in it almost any details they might wish to have for running the firm.

ADVANTAGES of the PARTNERSHIP

1 Ease of formation
2 Low start-up costs
3 Additional sources of venture capital
4 Broader management base
5 Possible tax advantage
6 Limited outside regulation

Visual No. 11–4

Although businessmen often think of the partnership as a unit separate and apart from the persons who are the partners, and although it is treated for accounting purposes as such a unit, U.S. law usually does not regard the partnership as a legal entity. Legally, it is simply a number of individuals. The assets of the business are viewed as belonging to the partners, and they are personally responsible for its debts.

DISADVANTAGES of the PARTNERSHIP

1 Unlimited liability
2 Lack of continuity
3 Divided authority
4 Difficulty in raising additional capital
5 Hard to find suitable partners

Visual No. 11–5

Members of a partnership have equal rights in the firm's management and in the conduct of its business. Persons dealing with the firm are not affected by agreements among the partners which limit the authority of some partners, at least if the outsiders do not know of those agreements. Each partner is an agent of the firm and of the partners. Therefore, even a partner who is not particularly experienced or skilled in business affairs has the power to enter into contracts or other transactions which will be binding on his copartners. This drawback in the partnership form in part explains its limited use by larger businesses.

Corporation

The corporation is an association of individuals which has a separate legal personality; in other words, it is recognized by law as having an existence separate and apart from the individuals (shareholders) who own it. Rights, duties, and other legal relations arising out of the enterprise are adjusted as though the corporation were a separate individual. The shareholders have in theory only an indirect interest in the assets of the corporation, which is represented by their right to share in dividends and in the distribution of corporate assets on liquidation. The corporation holds property, enters into contracts, transfers property, and conducts legal matters in a capacity separate and distinct from its shareholders. The separateness of the corporation is also generally recognized for tax purposes, the corporation being considered a "tax entity."

ADVANTAGES of the CORPORATION

1. **Limited liability**
2. **Specialized management**
3. **Ownership is transferrable**
4. **Continuous existence**
5. **Legal entity**
6. **Possible tax advantages**
7. **Easier to raise capital**

Visual No. 11-6

The corporation is sometimes referred to as "a creature of statute." This means that a corporation can only be formed by compliance with requirements set forth in the corporation statutes of the State where the corporation is being organized. Incorporation papers setting forth certain basic information such as the corporation's name, the business it is to conduct, and its capital structure must be prepared and filed with certain responsible public officials. Such a document is referred to as the "charter," "articles of incorporation," or "certificate of incorporation."

Unlike the partnership, whose internal operations can be governed entirely by a private contract, a corporation's financial structure and management pattern must conform, in some degree, to standards set out in the corporation statutes. For example, a common prerequisite to operation as a corporation is that a specified minimum amount of capital must be contributed by the organizers of the business.

The traditional advantages of the corporation are usually listed somewhat as follows: (1) The liability of the shareholders on business obligations, and therefore their risk, is limited to the amount they pay for their shares. (2) The management of the enterprise can be centralized in a board of directors, thereby permitting selection of experts as managers of the business (whether or not they are shareholders) and excluding from management any persons among the owner group who do not possess desired skills or experience. (3) The enterprise has a continuous existence, *i.e.*, the business organization is not dissolved by the death, insanity, or withdrawal of an owner. (4) An interest in the business, evidenced by stock certificates, is easily bought or sold, thus usually permitting a dissatisfied owner to withdraw from the enterprise without serious financial loss. (5) Capital can be attracted in larger amounts and more readily than when some other type of organization is used. As will be pointed out in greater detail later, many of these traditional advantages of the corporation form are really not necessary or desirable in most small enterprises.

DISADVANTAGES of the CORPORATION

1 Closely regulated

2 Most expensive form to organize

3 Charter restrictions

4 Extensive recordkeeping necessary

5 Double taxation

Visual No. 11-7

Limited Partnership

The limited partnership, a variation of the partnership authorized by statute in most States, permits persons who want to contribute capital to an enterprise to avoid the unlimited liability of general partners by becoming special or limited partners in a firm. To obtain limited liability for the special partners, the organizers of the enterprise must carefully follow a procedure set forth in the limited partnership statute. In general, this means that they must draw up articles of limited partnership and file a copy of those articles with a public official. The statutes also require that a limited partnership have at least one general partner whose liability will be unlimited.

Many businessmen and lawyers do not use the limited partnership, because they fear that the special partners' limited liability might be lost through an inadvertent failure to comply strictly with the requirements of the Limited Partnership Act. When the limited partnership was first introduced in this country, that risk was certainly substantial. Now, however, under the Uniform Limited Partnership Act, which is in effect in many jurisdictions, there is no real danger of special partners losing the shield of limited liability if they and their attorneys use reasonable care in complying with the laws and other rules for setting up the limited partnership and observe the limitations placed by the statutes on the activities of limited partners. The limited partnership, however, is not a useful device for providing limited liability where, as is so often the case in a small business, investors desiring limited liability want to participate in the management and operation of the business. The reason for this is that special partners lose their immunity from personal liability if they participate actively in the affairs of the enterprise.

Partnership Association

Laws in a few States provide for a kind of business organization—the partnership association—that differs from the limited partnership in that all members have limited liability (as in a corporation) and interests in the enterprise are transferable (as are shares in a corporation). The partnership association, as a general rule, is considered a separate legal entity in the jurisdiction in which it is organized. Thus it may acquire and hold property, may sue, and is subject to suit in the firm name. Furthermore, such an association may be managed by a board of managers equivalent to a corporate board of directors. (Instructor's note: Illustrate with local regulations.)

The partnership association has a number of distinct disadvantages. Statutes set a minimum on the number of persons who may form such an association and usually place a limit on the duration of these associations, without providing a method for renewing the life of an association whose term has lapsed. Furthermore, failure to comply closely with statutory requirements for the formation of a partnership association or with rules governing its operation might result in unlimited liability being imposed on its members. This risk of unlimited liability for failure to comply with statutory regulations is probably somewhat greater in a partnership association than in a corporation.

Another disadvantage of the partnership association is that a transferee of an interest in such an organization does not become an associate in the business unless he is elected to membership by the partners. If the transferee is not elected, he is merely entitled to have the association buy his interest. This rule tends to restrict the transferability of interests in a partnership association because a purchaser can never be sure that he will be elected to membership.

Jurisdictions other than the one in which a partnership association is formed do not consistently recognize the association as an entity and may treat it as an ordinary partnership. The Federal Government, however, taxes it as a corporation because it comes within the statutory definition of an "association."

Unincorporated Association (Joint-Stock Company)

From one point of view, the joint-stock company is simply a variation of the partnership form. The articles of association of a joint-stock company, just as the articles of partnership, is a private contract; and in early legal theory a joint-stock company was simply a partnership whose characteristics had been modified by contractual arrangement among the participants. The principal disadvantage which the joint-stock company has in common with the partnership, even where the joint-stock company has been recognized by law, is that the associates do not have limited liability.

Business Trust

The "Massachusetts" or business trust is a business organization created by a deed or declaration of trust under which assets suitable for a business enterprise are transferred to trustees to be managed for the benefit and profit of persons holding transferable certificates evidencing the beneficial interests in the trust estate. The trustees have legal title to the property in trust and act as principals for the certificate holders. As one author has commented, the business trust "is a common law device invented to give continuity of life and limited liability to the owners of shares in the trust, thus providing two of the main advantages of the corporation."

A principal disadvantage of the business trust is its rather shaky legal foundation. Some States refuse to recognize the business trust as a separate form of business organization and apply to it the rules governing partnerships or joint stock companies. The result in those jurisdictions is that beneficiaries of a business trust do not obtain limited liability. Furthermore, like the partnership association, the business trust is an "association" for tax purposes, and therefore is taxed the same as a corporation.

Close Corporation

Some businessmen feel that the corporation is unsuited to a small business because it is designed for use by large enterprises requiring the accumulation of capital from widely scattered investors. Nevertheless, the fact is that a business can be incorporated even though it is to be owned by only a few persons, by members of one family, or even by a single individual. Thus, incorporation (with the accompanying limited liability, perpetual existence, and, in many situations, important tax advantages) is available not only to large groups of investor-shareholders, but also to a few prospective participants desiring to organize a business and manage it themselves.

Characteristics of a Close Corporation

1. **Special charter and bylaw clauses**
2. **Long-term employment contracts**
3. **Shareholders' agreements**
4. **Irrevocable proxies and voting trusts**
5. **Restricted transferability of shares**
6. **Limited power for directors**
7. **Power of veto held by particular stockholders**

Visual No. 11–8

In the past, legislatures and courts have generally failed to recognize the distinctive problems of corporations which are owned by a relatively few shareholders and to provide suitable legal frameworks for corporations of that type. But some members of the corporate bar have exercised a great deal of imagination and ingenuity in eliminating those traditional attributes of the corporate form disadvantageous to small businesses and in tailoring the corporate form until it almost ideally fits closely held enterprises.

To provide serviceable arrangements for small businesses, lawyers have resorted to an interesting array of legal devices, such as special charter and bylaw clauses, long-term employment contracts, shareholders' agreements, irrevocable proxies, and voting trusts. Typically, these arrangements restrict the transferability of shares in small corporations, place limitations of various kinds on the powers of directors, and give particular shareholders power to veto corporate action. Through resourcefulness and persistence in modifying the corporate form to meet the needs of closely held enterprises, lawyers have created what is virtually a new form of business organization, the close corporation, with qualities, needs, and problems that differ widely from those of the public-issue corporation.

Subchapter S Corporation

A second modification of the corporate form is known variously as the pseudo-corporation, the small-business corporation, the tax option corporation, and the Subchapter S corporation. It first made its appearance in 1958 with the enactment of Subchapter S of the Internal Revenue Code. Whenever a corporation which meets the requirements of Subchapter S chooses the tax status there provided, corporate income is divided among the shareholders according to their ownership interest or other agreements and included in their individual tax returns. The separate being of the corporation is disregarded for Federal income tax purposes.

Subchapter S was enacted with the objective of enabling enterprises "to select a form of business organization desired, without the necessity of taking into account major differences in tax consequences." . It actually provides, however, for a form of business organization—the Subchapter S corporation—which is not only taxed differently from other corporations but also receives in some respects a tax treatment which varies from that of the partnership. Its popularity results from the fact that its use avoids the "double taxation" of corporate income without loss of such corporate advantages as limited liability and favorable tax treatment of "fringe benefits" to shareholder-employees.

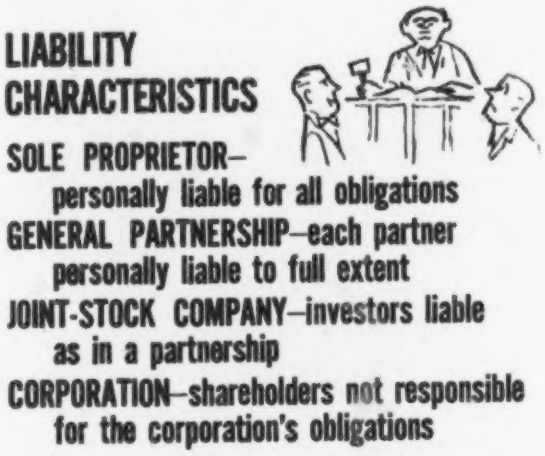
In order to qualify for election to be taxed under Subchapter S, a corporation must be a domestic corporation and not be a member of an affiliated group eligible to file a consolidated return, must have only one class of stock, and must not have more than 10 shareholders. Furthermore, all of the corporation's shareholders must be individuals or estates and none of them may be nonresident aliens. Also, the election will "terminate" (1) if 20 percent of the corporation's gross receipts in any year comes from dividends, rents, interest, annuities, royalties, or sales and exchanges of stock or securities, or (2) if 80 percent of gross receipts comes from sources outside the United States.

Whether the Subchapter S corporation should be considered a form of business organization distinct from the regular corporation is debatable. Some persons argue that it is simply a corporation with a few limitations on size and capital structure. However, because it is taxed differently from the regular corporation and because some of the requirements for qualifying for tax advantages under Subchapter S have the effect of limiting the flexibility of the corporate device, the Subchapter S corporation might well be thought of as a new and distinct type of business organization.

LIMITED LIABILITY: IS IT IMPORTANT?

Limited liability of the stockholders is one of the major advantages of the corporate form of doing business. Often an attorney advising persons starting a small business suggests that they incorporate so as to limit their liability to the funds they put in the enterprise in payment for their shares. This advice may be given without proper consideration of the possibility that, in some business situations, limited liability may not be particularly important. It is true, too, that the corporate form is *sometimes* an ineffective shield against the imposition of personal liability.

The attorney should determine whether the participants are putting substantially all their assets into the business and thus will not have outside assets which can be lost. He should keep in mind that, no matter what form of business organization is used, some personal assets will be protected by law and that insurance will be available to protect the participants against liability for negligence of employees and other potential liability.



LIABILITY CHARACTERISTICS

SOLE PROPRIETOR–
personally liable for all obligations
GENERAL PARTNERSHIP–each partner
personally liable to full extent
JOINT-STOCK COMPANY–investors liable
as in a partnership
CORPORATION–shareholders not responsible
for the corporation's obligations

Visual No. 11-9

The extent to which business forms other than the corporation provide limited liability should also be noted, as well as the likelihood that the limited liability the corporation provides to the participants in their capacity as shareholders will be lost by their incurring personal liabilities for their acts as directors or officers.

Liability Characteristics of Business Forms

A sole proprietor is personally liable for all the obligations of his business. This means that he risks every asset he owns which does not come under a debtor's exemption.

Partners in a general partnership are in a similar position. If a debt or liability on a contract is incurred by any of the partners or by a partnership agent while he is acting with actual, implied, or apparent authority, or if a tort is committed by a partner or employee acting in the scope of the firm's business, all partners are personally liable to the full extent of the claim. A partner's unlimited liability is not affected by the proportion of his interest in the firm. Thus, although a partner owns only a one-fourth interest in a firm, he is personally liable for the total amount of debts.

Unlimited liability in a partnership is somewhat reduced because a partner who is held responsible on a firm debt can be reimbursed from partnership assets. If there are no such assets, he can force his partners to contribute, that is, pay their pro rata share, assuming the other partners have property. Members of a partnership may contract among themselves how they will share the firm's debts and liabilities, but a contract of this kind has no effect on the rights of a tort or contract claimant.

Investors in joint-stock companies, whether organized under the common law or under statutes, do not have limited liability. They are liable for obligations of the business in the same way as members of a general partnership.

As a general rule, shareholders in a corporation are not responsible for the corporation's obligations. A shareholder pays an amount for his shares which is usually at least the par value of shares with a stated or face value. That is the end of his responsibility to provide capital to meet needs of the corporation or its creditors. Statutes imposing double liability on shareholders in certain types of corporations have largely disappeared.

Usefulness of Insurance in Protecting Against Risks

Selection of a business form that provides limited liability for all or some of the participants (a corporation, a limited partnership, a partnership association, or a business trust) is not the only way to shield the participants from the risks of a business. Certain risks may be protected against by the use of insurance. Public liability, workmen's compensation, and other tort liability, for example, may be covered by insurance. Loss of rental income is also insurable. Of course, businessmen ordinarily cannot insure themselves against losses resulting from business failure and against liability arising out of business contracts. Thus, the electrician cannot take out insurance which will protect him against his competitors' adopting new methods that will force his business to the wall. Nor will he normally find it practicable to insure against contract liability in the event his enterprise fails to perform a subcontract on a large construction project.

REMOVING PERSONAL ASSETS FROM CREDITORS' REACH

Another method of limiting liability is to remove personal assets of the participants from the reach of creditors. The precise method depends upon various State laws. To do this, the participants transfer title to their personal assets to their wives, or they create estates by the entireties so that creditors of neither husband nor wife can reach the assets. These methods are not without dangers. There is the risk of divorce or of the wife's dying. Furthermore, the conveyance may be set aside as a fraudulent conveyance. Section 5 of the Uniform Fraudulent Conveyance Act states that any gratuitous conveyance made when the conveyor is engaged in or is about to engage in business that is undercapitalized is fraudulent.

CONTINUITY OF ENTERPRISE AS A FACTOR IN CHOICE OF BUSINESS FORM

Persons organizing a business usually want to insure that it will continue. They may wish to avoid a forced liquidation of their firm if a partner dies or withdraws, they may desire to pass on to their wives or children a profitable business, or they may simply hope that some creation of theirs will survive them.

While the proper choice of business form can guarantee the legal continuity of a business, many lawyers and businessmen overlook the very real possibility that continuing the business may be undesirable. Business continuity is often broken by a failure to develop adequate managerial skills in junior personnel and by an inability to obtain new talent to replace those persons who die or retire.

How Business Form Affects Continuity

As a rule, death or withdrawal of a participant has a more serious effect upon the continuity of a single proprietorship or general partnership than it does upon a corporation, limited partnership, partnership association, business trust, or joint-stock company. Even though the law places no time limit on a single proprietorship, illness or the incapacity of the owner may seriously damage the business and his death may terminate it.

Withdrawal or death of a partner legally ends the partnership, and leads to a winding up and a liquidation of the enterprise. Even though a partner has agreed not to leave the firm, he has the power to withdraw at any time, subject to liability for any damage caused. Furthermore, forces beyond a partner's control, such as his bankruptcy or incapacity, will work a legal dissolution no matter what the partner's intent. Often the former partners who are able and wish to carry on the business can form a new partnership quickly enough to capture completely the business of the former partnership.

In a corporation, irrespective of whether it is a public-issue corporation or a close corporation, death of a shareholder or the sale of his shares does not affect the corporation's legal existence. In legal thinking, subject to certain exceptions not important here, it does not matter who owns the corporation's shares.

Business Form and Continuity

SINCE
1865
100th
ANNIVERSARY
SALE
100 YEAR SALE

Single proprietorship—may terminate
General partnership—liquidation
Corporation—no effect
Subchapter S corporation—serious problems
Limited partnership—partner may withdraw
Partnership association—no effect
Business trust—no effect
Joint-stock company—no effect

Visual No. 11–10

The Subchapter S corporation, however, encounters a serious continuity problem. Its general corporate character is not affected differently from the other corporate forms, but whether or not it will continue to be allowed the tax option benefit depends upon a number of factors. Even though the corporation has met all of the preliminary requirements on the first day of the first taxable year in which the election was made, or the date of the election if that is a later date, it will lose its special status if any one of the following happens during the taxable year:

1. Any new shareholder fails to give his consent to the tax option election,
2. More than 20 percent of the corporation's gross receipts comes from royalties, rents, dividends, interest, annuities, and gains on sale or exchanges of stock or securities,
3. More than 80 percent of its gross receipts comes from sources outside the United States, or
4. Any one of the preliminary requirements is no longer satisfied.

These are: (a) that there be 10 or fewer shareholders, (b) that all shareholders be individuals or estates, (c) that there only be one class of stock, (d) that no nonresident alien be a shareholder, (e) that the corporation not be a member of an affiliated group eligible to file a consolidated return, and (f) that the corporation be domestic.

The corporation is not the only form by which legal continuity can be achieved. If sufficient assets remain to pay any liabilities of the firm, a limited partner may withdraw from the limited partnership. This may be done by dissolving the partnership, on a date specified in the certificate for withdrawal or on 6 months' notice to the other members if the certificate did not set a date for withdrawal or dissolution. A long restriction upon the limited partner's rights to withdraw may be imposed in the certificate.

The interest of a limited partner is freely transferred, and the new owner may become a substituted limited partner by consent of the other members or by a certificate provision giving the limited partner power to substitute a new limited partner in his place. Death of a limited partner does not dissolve the firm because the deceased's estate may be substituted for the deceased; the executor or administrator may transfer the interest. It must be remembered, of course, that the death or withdrawal of a general partner in a limited partnership may have substantially the same effect on operations that it would have in a general partnership.

Because the shares of a partnership association are freely transferable, there is no danger of dissolution upon the death or transfer of any interest. The statutes do, however, place a limited life upon a partnership association, usually 20 years, and make no provision for renewal as most corporation statutes do.

Interests in a business trust or joint-stock company are as freely transferable as are shares in a corporation. Thus, in these two forms, the death or withdrawal of an owner does not affect the life of the business unit.

USING DIFFERENT FORMS IN THE SAME ENTERPRISE

You, as owners and managers of business, should not overlook the possibility that you may be able to use several business forms at the same time for personal and business advantage. Perhaps you might want a corporation and a partnership or two in setting up a legal structure to handle your affairs. We will not attempt to explore the considerations involved in deciding how many business forms should be used in setting up a business. That subject, particularly the tax aspects of it, is sufficiently difficult and complex to justify a separate study. Whether an enterprise should be broken into several more or less independent units, each conducted under a different business organization, is a question that usually arises in a large enterprise with many varied activities or with activities in more than one geographical area.

On occasion, several business forms can be used to advantage even in a small enterprise. Here is one example. A partnership, engaged in the manufacture and sale of soft drinks, built up over a period of years a highly successful and profitable business. All went well until one of the partners married a wealthy woman. Then he began to spend far less time than before on partnership affairs. He devoted most of his time to golf, his club, or other recreation. His partners became unhappy because they felt that they were bearing more than their share of the burden of the firm's operations.

In order to stop strife and dissension, the firm's lawyer had the partners rearrange their business operations as follows: each partner was given a separate sales territory which he worked as an individual; the manufacturing plant was operated as a partnership, but with costs of operation and maintenance allocated to each partner on the basis of his sales. Partnership profits were divided on the basis of sales. By this use of several business organizations, the breakup of a successful small business was avoided, and earnings were distributed to the owners roughly according to their contributions to the firm.

"CUSTOM TAILORING" A FORM FOR YOUR NEED

Because individual needs, goals, and situations in business vary so greatly, the form which you choose to conduct your own firm must be "custom made." Through the resourcefulness of the legal profession, it is now possible for the traditional legal forms to be shaped to create a custom form that will best serve you.

The characteristics of the various legal forms of business organization are determined by State law. Because of the variations in State law, you should discuss these laws with an attorney familiar with the particular State to find out exactly what alternatives exist.

Once the characteristics of the forms available in your area are known, an examination of the particular situation of your business and its participants will determine whether individual characteristics of each organizational form can help or hinder. These must be weighed against one another; the choice of business form is important and cannot be slighted by those who seek business success. Limitation of personal liability, continuity of business existence, ease of management and control, availability of needed capital, and the relative cost of operation through the various legal forms are matters which must be considered. Only then can you select a business form that will best serve you.

THE FRANCHISE SYSTEM

The franchise system of distributing goods and services has come of age since World War II. It employs new organizational and marketing techniques which are changing basic distribution patterns and should be of particular interest to almost anyone looking for opportunities in small business.

In its simplest terms, a franchise is a contract between an independent businessman (the franchisee) and a market supplier of goods or services (the franchisor) in which the businessman is given the exclusive right to sell these goods or services in a specified geographical area. The franchisee has the benefit of the parent company's reputation and established name in addition to its experience and help in choosing a location, financing, marketing, recordkeeping, and product promotion. In return, the franchise holder usually makes a financial investment in the business, agrees to pay a commission on gross sales, and purchases supplies or equipment from the parent company or consents to a combination of these possibilities.

Early use of franchising as an effective method for distributing goods and services was made by the automobile industry and the refiners of oil products—both of whom needed mass distribution. Since World War II, franchised operations have expanded rapidly into many lines, including the following:

Automatic dry cleaners
Auto products and services
Auto parts stores
Beauty salons and products
Building improvements
Carpet and upholstery cleaning
Credit and collection services
Doughnut shops
Health aids and services
Industrial products and equipment
Insect and pest controls
Lawn care products and services
Motels
Paint stores
Pancake shops
Drive-ins and carry-outs
Soft ice cream units
Sport and recreation
Swimming pools
Water conditioning equipment

By 1964, there were about 340,000 franchised business outlets in the country according to the International Franchise Association. The industry breakdown by major types of business is as follows:

	Number
Gas and oil stations	206, 000
Coin-operated laundries and drycleaning centers	35, 000
Automobile dealers	30, 000
Roadside food and beverage establishments	24, 600
Grocery stores	16, 000

	Number
Moving companies	5, 000
Soft-drink bottlers	4, 000
Carpet and upholstery cleaners	4, 000
Hearing aid firms and variety stores	3, 500
Water conditioning services	2, 300
Other	9, 600
Total	340, 000

Advantages of Franchising

In spite of this rapid growth, the careful businessman must look at all sides of a franchise operation before taking such an important step. Here are some of the possible advantages of franchised operations:

1. Capital investment is less than is normally called for in a comparable non-franchise business because financial assistance is often available through the parent company.

2. Working capital requirements are usually similarly reduced because of financial assistance and good inventory controls.

ADVANTAGES of FRANCHISING

1 Smaller than usual capital investment
2 Less working capital than normally required
3 Product or service usually has prior public acceptance
4 Inexperience and limited education less of a handicap
5 Management assistance
6 Better than average profit margins are typical

Visual No. 11–11

3. A proved product or service can be offered with established public acceptance.

4. Inexperience and limited education are less of a handicap with management assistance provided by the franchisor.

5. The better franchising companies provide management assistance on a continuing basis, in financing, recordkeeping, advertising, marketing, and product promotion.

6. The franchisee can usually expect good profit margins because the whole operation is run with chain-like efficiency.

7. Because the franchisee and franchisor both benefit from the success of the operation, both work hard to achieve it.

Disadvantages of Franchising

Possible disadvantages are:

1. Franchisor fees, prices for supplies, and other charges may be too high for the local market.

2. The franchisee loses some of his independence in conforming to the national pattern of operation.

DISADVANTAGES of FRANCHISING

1 Franchisor fees, supplies, and charges may be high
2 Some loss of independence
3 Contract may be difficult to cancel
4 Possible problems working with franchisor agents

Visual No. 11–12

3. With a long-term franchise agreement, it could be difficult and expensive to cancel out without cooperation from the franchise company.

4. In some cases, the franchisor's field men may be slow to adapt their methods to meet local conditions.

5. The local operator may lose some opportunity to use his own ideas because of standardized procedures.

A survey by the Gallup Poll revealed that 68 percent of all Americans would like to have a business of their own. Perhaps this helps explain why more than 400,000 new businesses are started each year.

On the other side of the coin, the picture is far from bright. Estimates place business discontinuances between 350,000 and 400,000 each year. This high rate of turnover wastes billions of dollars each year.

A substantial proportion of the retail businesses which fail—almost two-thirds, in fact—are in operation only 5 years or less. The great majority of these failures can be traced to inexperience, incompetence, and other shortcomings in management qualifications. Since one of the major advantages of a good franchise operation is management training and assistance, a further expansion of franchising into the retailing community could be a stabilizing factor.

Locating a Franchise

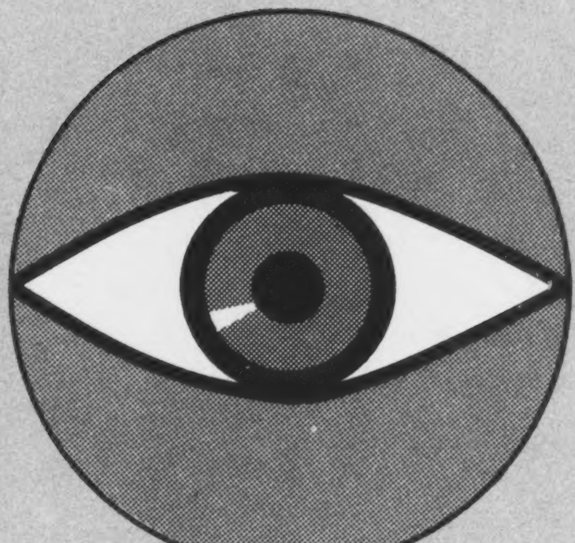
Let us suppose one of you is interested in a franchise. You usually learn of a franchise opportunity by writing directly to the parent company or responding to its advertisement in the business opportunities section of a newspaper or trade journal. Following this, there should be a mutual exchange of references and a thorough evaluation of the proposition by you and your business advisors.

After a check of bank references, you should obtain detailed reports on the franchise company from the Better Business Bureau and possibly Dun & Bradstreet. Other franchise holders should be interviewed. If the proposition still looks promising and you have all the facts at hand, then you should make a visit to the home office of the parent company for a final "look-see."

In any event, prior to signing a contract or making a cash deposit, you should go over the agreement with your lawyer or accountant. The standard franchise contract can then be reviewed and amended to best serve your own interests.

A major cause of small-business failure can be traced to weaknesses in management experience and aptitudes. The more successful franchise operations, on the other hand, provide extensive management assistance and training to their franchisees on a continuing basis in recognition of this basic problem.

For this reason, do not overlook possible opportunities in business franchising when you are considering going into a business of your own.



THE VISUAL AIDS

A What to Show

Section

The old Chinese proverb **"One See Worth Thousand Say"** is certainly borne out by experience in the fields of education and training at all levels.

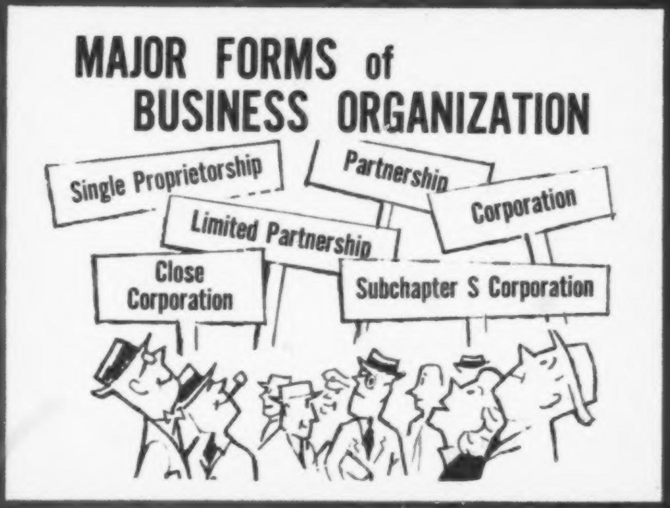
The instructor who helps his participants **visualize** subject matter and ideas not only holds the group interest--he also stimulates thoughtful consideration and retention of the topic.

This section contains samples of visuals that are available for this subject. Each has been carefully coded and "keyed" into **The Lesson Plan** as outlined in this manual.

USE OF VISUAL AIDS

WHAT TO USE	WHEN AND HOW TO USE
Chalkboard 	Study and plan before a meeting what to put on the board and where to put it. Use it to present sketches, diagrams, outlines, definitions, key words, directions, record of class contributions, and summaries. Suit material to board space. Write plainly and quickly. Keep wording simple. Stand at one side of board while referring to material. Talk to the group, not to the board. Erase material no longer needed.
Posters, Charts, and Diagrams 	To arouse interest and attract attention; to show relationships and trends; to inspire group. Use device large enough to be seen. Post where everyone can see. Present at right time. Discuss information illustrated.
Hand-Out Materials 	To present information uniform in character and as a guide to material covered; emphasize key points; arouse interest and discussion; review or summarize discussions; and serve as permanent reference. Select to serve a definite purpose. Introduce at right time. Distribute in manner to convey its importance. Direct members how to use.
Films and Film Strips 	Present an overall view; introduce a new subject; emphasize specific aspects of a subject; arouse interest; summarize. Select carefully to relate to the discussion and plan presentation. Arrange room and equipment for showing. Alert the audience for the showing or what will be seen. Run the film. Discuss the subject matter and summarize.
Samples, Forms, and Exhibits it's the BEST	Keep subject matter practical; show development of a process; increase understanding. Select only enough to illustrate, not confuse. Pass around if necessary. Take time to present clearly. Comment when presenting.
Pedestal Chart MAKE it Count	A pad of newsprint sheets or similar paper may be used for the same purposes as the chalkboard. Material recorded with chalk or crayon may be saved for future reference by the group or by the instructor.

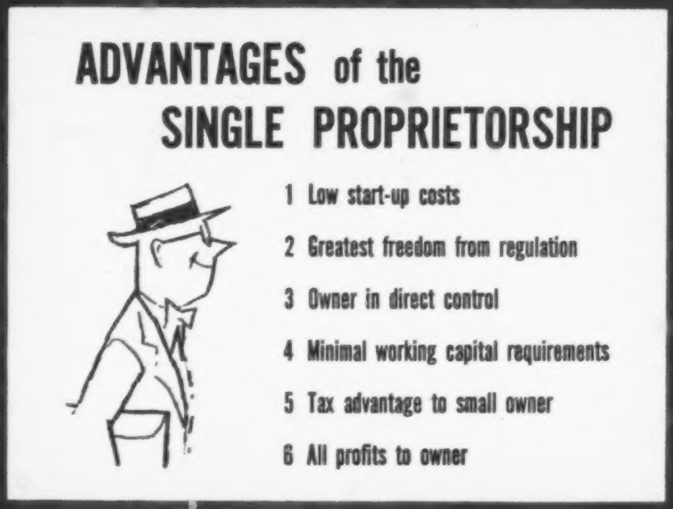
OVERHEAD PROJECTUALS



①

MAJOR FORMS of BUSINESS ORGANIZATION

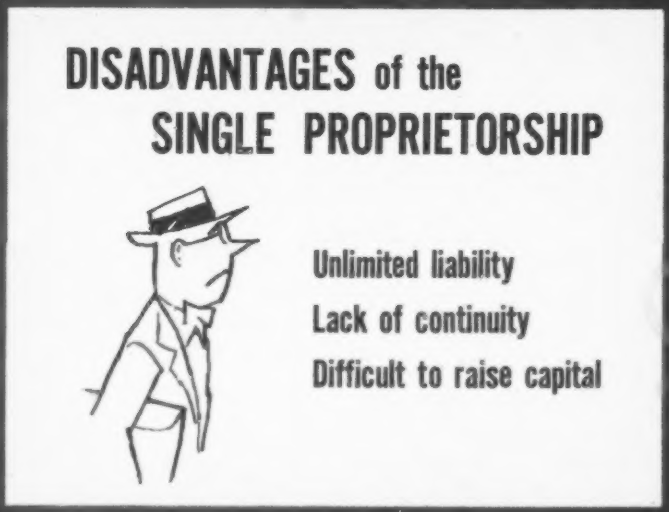
Single Proprietorship
Partnership
Corporation
Limited Partnership
Close Corporation
Subchapter S Corporation



②

ADVANTAGES of the SINGLE PROPRIETORSHIP

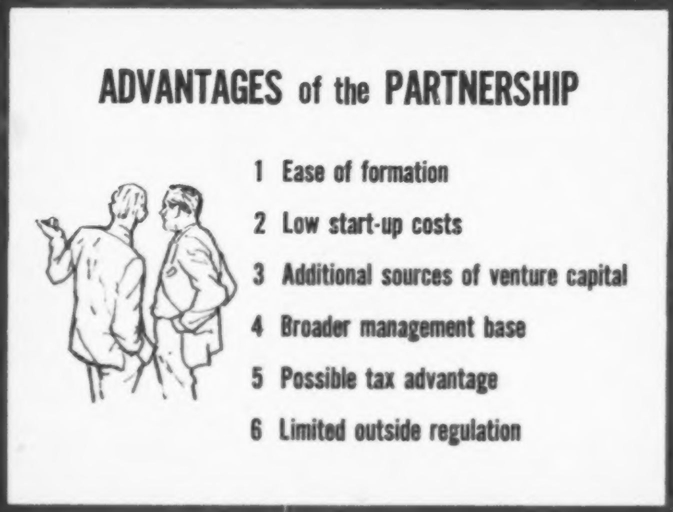
1 Low start-up costs
2 Greatest freedom from regulation
3 Owner in direct control
4 Minimal working capital requirements
5 Tax advantage to small owner
6 All profits to owner



③

DISADVANTAGES of the SINGLE PROPRIETORSHIP

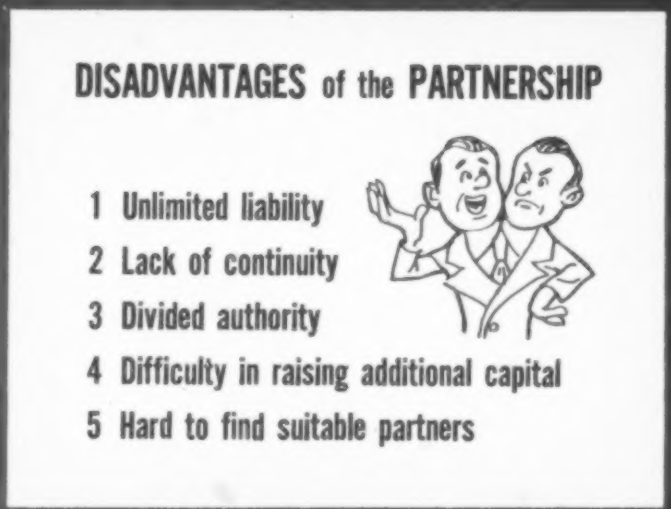
Unlimited liability
Lack of continuity
Difficult to raise capital



④

ADVANTAGES of the PARTNERSHIP

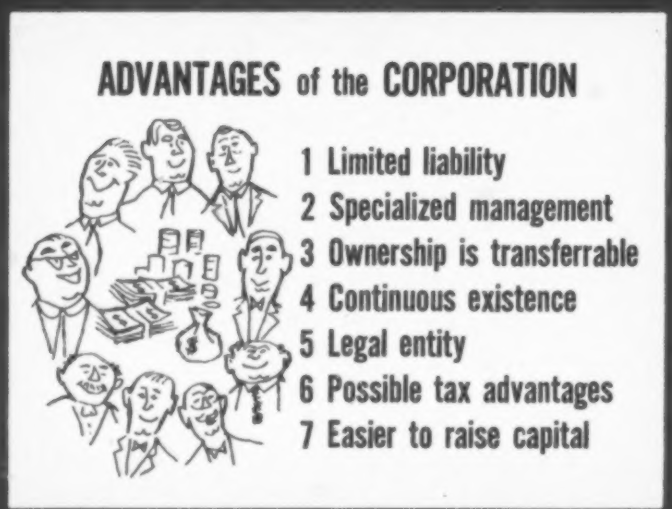
1 Ease of formation
2 Low start-up costs
3 Additional sources of venture capital
4 Broader management base
5 Possible tax advantage
6 Limited outside regulation



⑤

DISADVANTAGES of the PARTNERSHIP

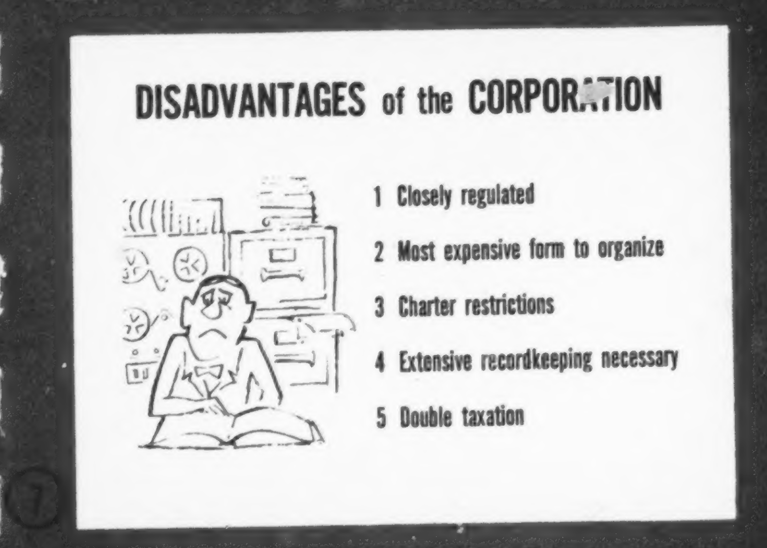
1 Unlimited liability
2 Lack of continuity
3 Divided authority
4 Difficulty in raising additional capital
5 Hard to find suitable partners



ADVANTAGES of the CORPORATION

1 Limited liability
2 Specialized management
3 Ownership is transferrable
4 Continuous existence
5 Legal entity
6 Possible tax advantages
7 Easier to raise capital

OVERHEAD PROJECTUALS



DISADVANTAGES of the CORPORATION

1 Closely regulated

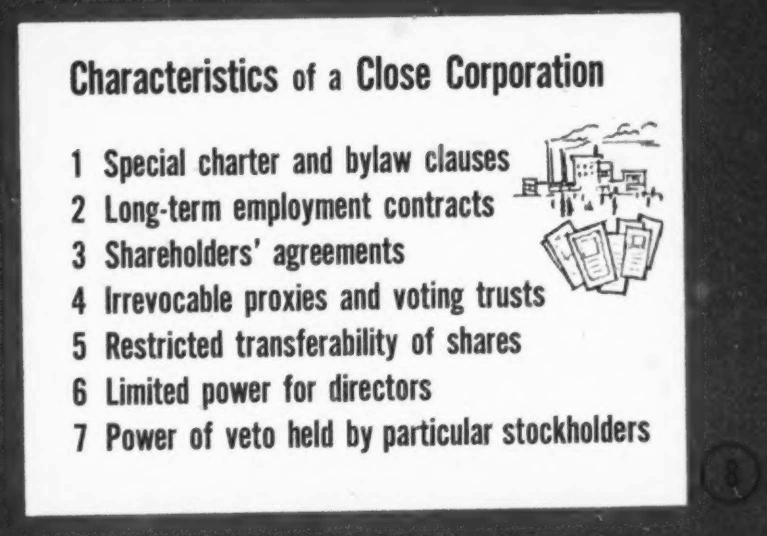
2 Most expensive form to organize

3 Charter restrictions

4 Extensive recordkeeping necessary

5 Double taxation

⑦



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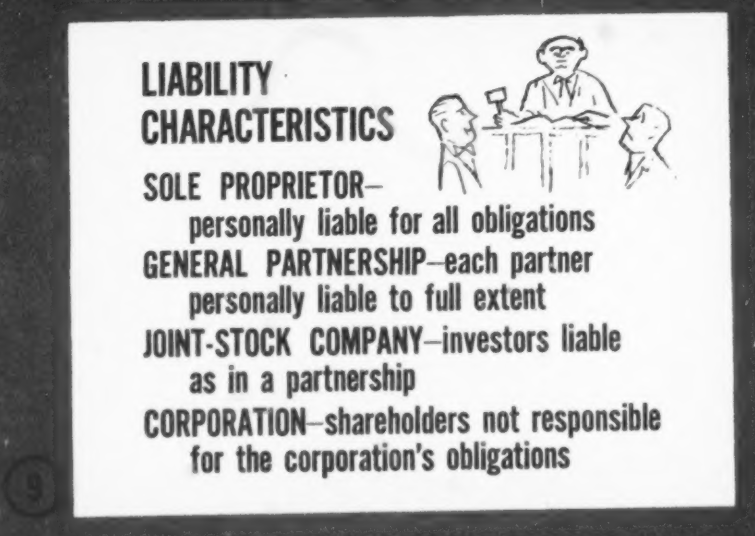
6 Limited power for directors
7 Power of veto held by particular stockholders

⑧



LIABILITY CHARACTERISTICS

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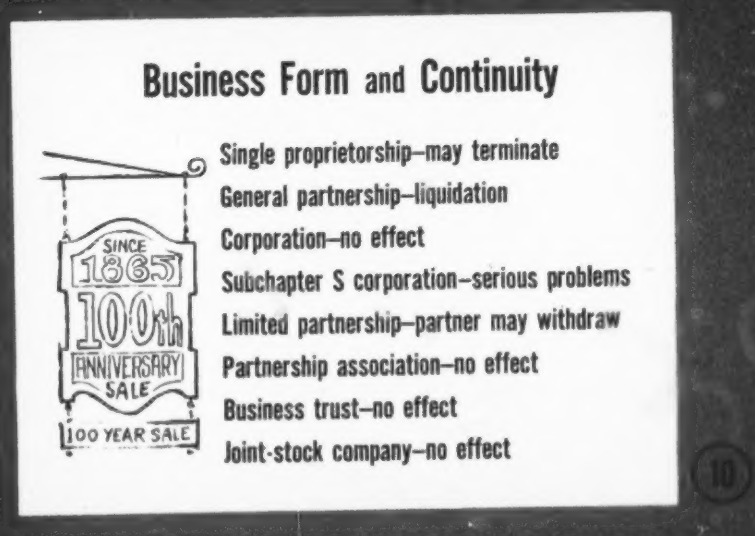
personally liable for all obligations
GENERAL PARTNERSHIP–each partner
personally liable to full extent
JOINT-STOCK COMPANY–investors liable
as in a partnership
CORPORATION–shareholders not responsible
for the corporation's obligations

⑨



Business Form and Continuity

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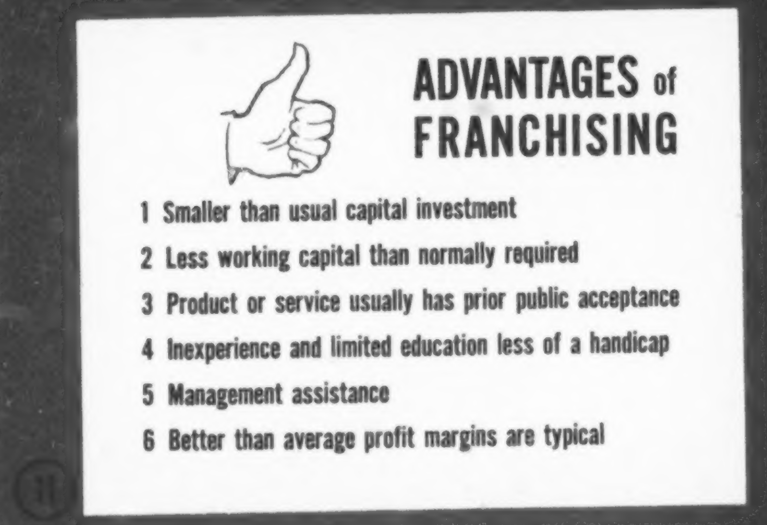
Subchapter S corporation–serious problems
Limited partnership–partner may withdraw
Partnership association–no effect
Business trust–no effect
Joint-stock company–no effect

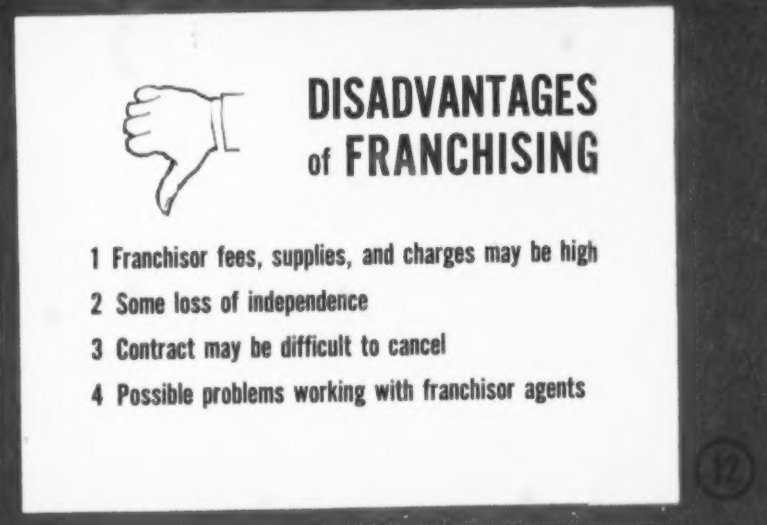
⑩



ADVANTAGES of FRANCHISING

1 Smaller than usual capital investment
2 Less working capital than normally required
3 Product or service usually has prior public acceptance
4 Inexperience and limited education less of a handicap
5 Management assistance
6 Better than average profit margins are typical

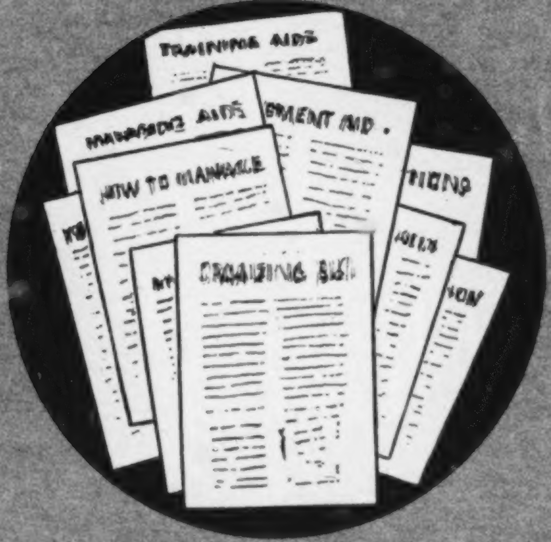
⑪



DISADVANTAGES of FRANCHISING

1 Franchisor fees, supplies, and charges may be high
2 Some loss of independence
3 Contract may be difficult to cancel
4 Possible problems working with franchisor agents

⑫



THE SUPPLY DEPARTMENT

A Resource Materials and Participant Handout

Section

It is generally conceded that interest intensifies in situations where people have a chance "to participate" by such means as open discussion and buzz sessions. The materials in this section should prove useful in this kind of activity. These materials may be reproduced locally.

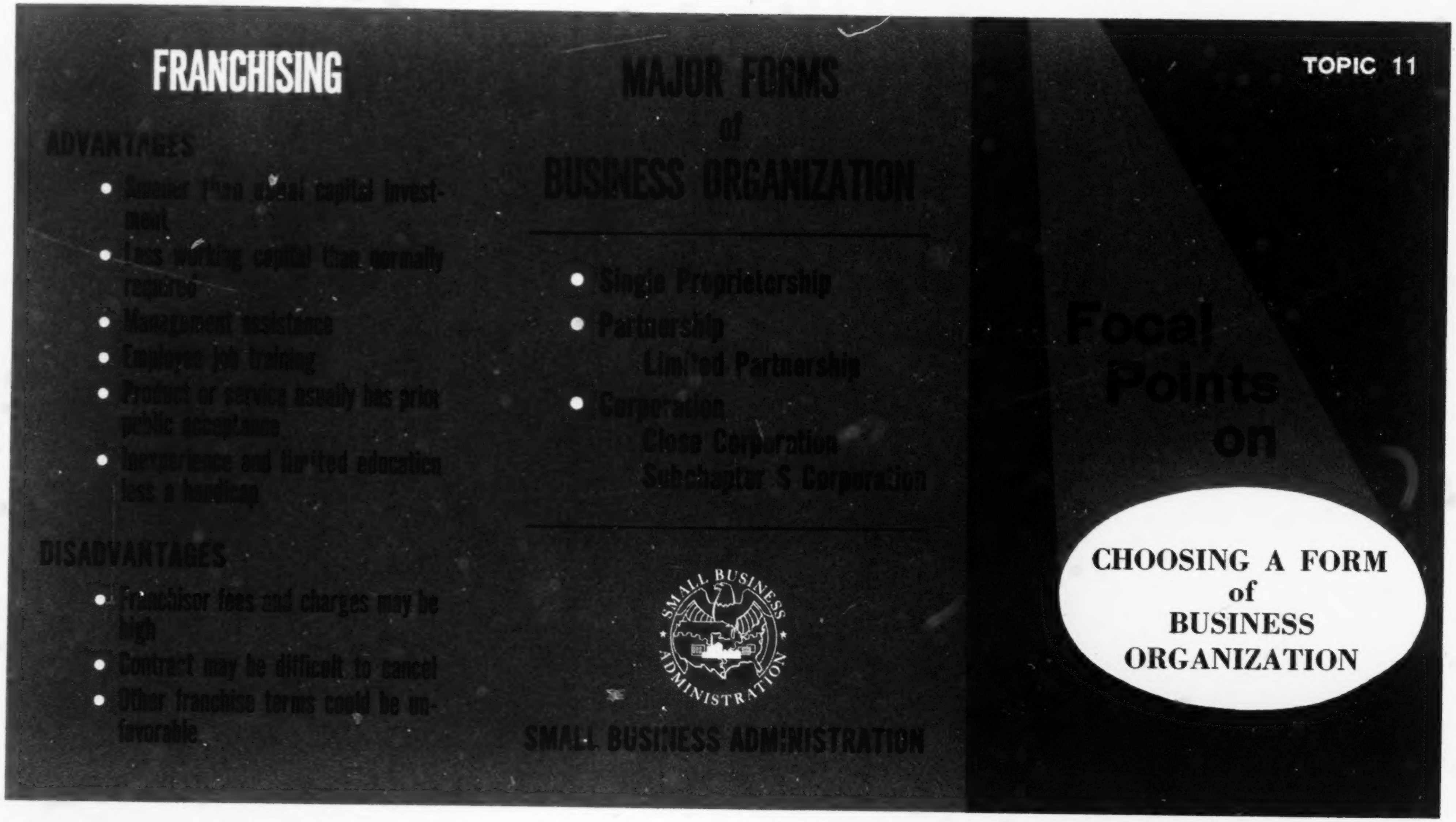
It is also desirable to provide participants with "take away" materials if they are pertinent and concise. Accordingly, appropriate Management Aids, Small Marketers Aids, and Management Research Summaries are included in this section. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

SUBCHAPTER S REQUIREMENTS

In order to qualify a corporation should:

1. Have individual shareholders.
2. Not have more than 10 shareholders.
3. Not have shareholders who are nonresident aliens.
4. Have only one class of stock.
5. Not have more than 80 percent of gross receipts from outside the United States.
6. Not have more than 20 percent of the corporation's gross receipts from royalties, rents, dividends, interest, annuities, and gains on sales or exchange of stock or securities.

Handout No. 11–1



FRANCHISING

ADVANTAGES

- Smaller than usual capital investment
- Less working capital than normally required
- Management assistance
- Employee job training
- Product or service usually has prior public acceptance
- Inexperience and limited education less a handicap

DISADVANTAGES

- Franchisor fees and charges may be high
- Contract may be difficult to cancel
- Other franchise terms could be unfavorable

MAJOR FORMS
of
BUSINESS ORGANIZATION

- Single Proprietership
- Partnership
  - Limited Partnership
- Corporation
  - Close Corporation
  - Subchapter S Corporation

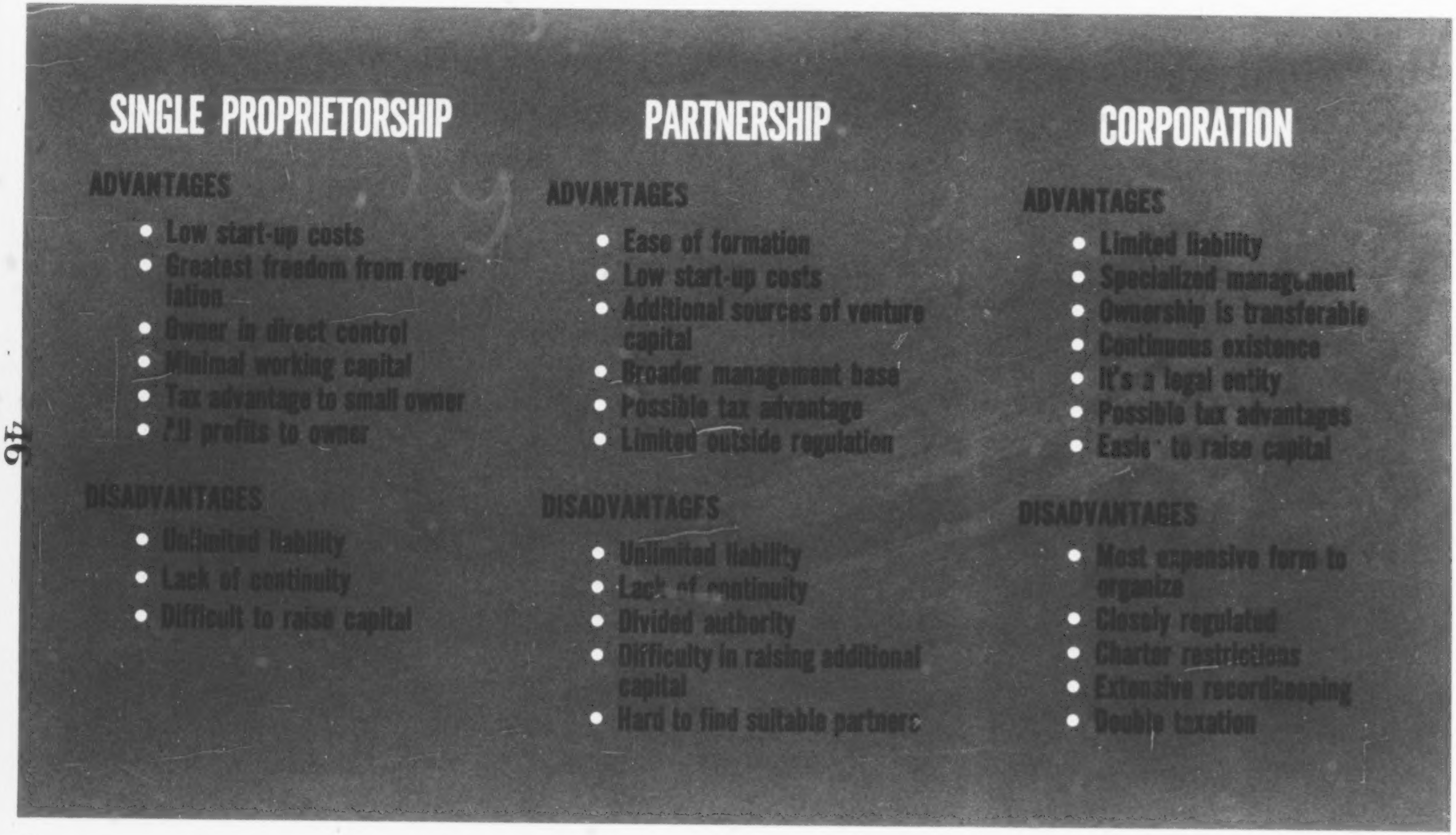
SMALL BUSINESS ADMINISTRATION

TOPIC 11

Focal
Points
on

CHOOSING A FORM
of
BUSINESS
ORGANIZATION

This page and the following illustrate a two-fold leaflet which summarizes the subject presentation. The leaflet is available in quantity from the nearest Small Business Administration office for distribution to participants in SBA-cosponsored administrative management courses.



SINGLE PROPRIETORSHIP

ADVANTAGES

- Low start-up costs
- Greatest freedom from regulation
- Owner in direct control
- Minimal working capital
- Tax advantage to small owner
- All profits to owner

DISADVANTAGES

- Unlimited liability
- Lack of continuity
- Difficult to raise capital

PARTNERSHIP

ADVANTAGES

- Ease of formation
- Low start-up costs
- Additional sources of venture capital
- Broader management base
- Possible tax advantage
- Limited outside regulation

DISADVANTAGES

- Unlimited liability
- Lack of continuity
- Divided authority
- Difficulty in raising additional capital
- Hard to find suitable partners

CORPORATION

ADVANTAGES

- Limited liability
- Specialized management
- Ownership is transferable
- Continuous existence
- It's a legal entity
- Possible tax advantages
- Easier to raise capital

DISADVANTAGES

- Most expensive form to organize
- Closely regulated
- Charter restrictions
- Extensive recordkeeping
- Double taxation

SMALL BUSINESS ADMINISTRATION
Management Aids *for Small Manufacturers*
Washington 25, D. C.

STEPS IN INCORPORATING A BUSINESS*

Adapted by members of the Office of the General Counsel, Small Business Administration, Washington, D. C.

SUMMARY

Many owners and managers have wondered: "What are the steps in incorporating a small business such as mine?" This kind of question may have occurred to you -- particularly if you are considering seeking equity capital.

This Aid contains no discussion of the advantages and disadvantages of the corporate form. (Some aspects of that subject are taken up in chapter 2, "Choosing the Legal Structure for Your Firm," *Management Aids for Small Manufacturers: Annual No. 5;* Superintendent of Documents, Washington 25, D. C., 1959, 45 cents.) Rather, this Aid is limited to the steps involved once a decision to incorporate has been made. Moreover, the information offered is not intended as a substitute for professional advice. Although small businesses sometimes are incorporated without the help of experienced corporation attorneys, professional legal guidance usually will result in a better corporate charter and a saving, in the long run, of both time and money.

Laws governing the procedure for obtaining a corporate charter vary with the individual State. Detailed information about the requirements of your State can be obtained from your Secretary of State or other State official who supervises granting of corporate charters.

REQUIREMENTS FOR INCORPORATION

Generally, the first step in the required procedure is preparation, by the incorporators, of a "certificate of incorporation." Most States require that this certificate be prepared by three or more legally qualified persons in a manner prescribed by State law. Frequently, the certificate must designate the names and addresses of the persons who are to serve as the directors until the first meeting of the corporation. (The certificate is discussed in more detail in a later section of this Aid.)

If the designated State official determines that the name of the proposed corporation is satisfactory, that the certificate contains the necessary information and has been properly executed, and there is nothing in the certificate or in the corporation's proposed activities that violates State law or public policy, he will issue the charter.

Thereafter the stockholders must meet to complete the incorporation process. This meeting is extremely important, and usually is conducted by an attorney or someone familiar with corporate organizational procedure.

In the meeting the corporate by-laws are adopted and a Board of Directors is elected. This board of directors in turn will elect the officers who actually will have charge of the operations of the corporation -- for example, the president, secretary, and treasurer. In small corporations, members of the board of directors frequently are elected as officers of the corporation.

The by-laws of the corporation may repeat some of the provisions of the charter and State statute, but usually cover such items as:

1. Location of the principal office and other offices of the corporation.
2. Date and place of stockholders' meetings, and provision for calling and conducting the meetings.
3. Necessary quorum for the stockholders' meetings.
4. Voting privileges of stockholders.
5. The number of directors, method of electing them, and method of creating or filling vacancies in the board of directors.
6. Time and place of directors' meetings, and requirements for a quorum.
7. Method of selecting officers, their duties, terms of office, and salaries.
8. Stock certificates, their transfer, their control in the company books, and the right to declare dividends.
9. Power to amend by-laws.

Information Required in Certificate of Incorporation

Many States have standardized certificate of incorporation forms which may be used by small businesses. Copies of this form may be obtained from the State official who grants charters and, in some States, from local stationers as well. The following information usually is required.

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*Adapted from Business Service Bulletin No. 24, by Goodreau Soper, U. S. Department of Commerce (out of print).

1. ***The corporate name of the company.*** -- Legal requirements generally are: (a) That the name must not be so similar to that of any other corporation authorized to do business in the State that the names might be confused; and (b) that the name chosen must not be deceptive so as to mislead the public. In order to be sure that the name which you select is suitable, it would be well to submit it to your State officer handling incorporation for check against his lists before you prepare the certificate of incorporation.

2. ***Purposes for which corporation is formed.*** -- Great care should be taken in writing this section because in some States the activities of the corporation will be limited to the powers set forth here. If so, you must petition your State incorporation officer for an amendment to the charter before deviating from these approved activities.

In some States, the corporation laws are very rigid, protecting the right of a corporation to expand its activities, and at the same time limiting such expansion to activities related to those specified in its certificate of incorporation. When this is the case, the object for which the corporation is being formed may be stated precisely and simply, since the corporation's rights are protected and its activities limited by the corporation laws.

In States where the corporation laws are less rigid, however, the purposes of the corporation may be presented in broad legal terms which will protect the right of the corporation to expand its future activities, including entry into other lines of business. For example, a corporation may have several specific statements to set forth its objectives, with one of these statements sufficiently inclusive to allow for future contingencies. Typical of such phrasing is the statement, "the foregoing acts will be interpreted as examples and not as limitations."

3. ***The length of time for which the corporation is being formed.*** -- This may be a period of years or may be perpetual.

4. ***The names and addresses of the incorporators.*** -- In certain States one or more of the incorporators is required to be a resident of the State within which the corporation is being organized.

5. ***Location of the principal office of the corporation in the State of incorporation.*** -- Although most small corporations find it advisable to obtain their charter from the State in which the greater part of their business is conducted, you should consider the benefits which may be gained from incorporating in another State. Such factors as cost of organization fees, State taxes, restrictions on corporate powers and lines of business in which a company may engage, capital requirements, restrictions upon "foreign" corporations in your State, and so forth should be taken into consideration in the selection of the State of incorporation.

If you decide to obtain your charter from another State, you will be required to have in it an office. However, rather than establish an office there, you may appoint an agent to act for you. The agent will be required only to represent your corporation, maintain a duplicate list of stockholders, and to receive or reply to suits brought against the corporation in the State of incorporation.

6. ***The maximum amount and type of capital stock which the corporation wishes authorization to issue.*** -- Allowance should be made for a greater amount of capital stock than is really needed at the time of incorporation.

7. ***Capital required at time of incorporation.*** -- Some States require that a specified percent of the par value of the capital stock be paid in cash and banked to the credit of the corporation before the certificate of incorporation is submitted to the proper State official.

8. ***The names of the subscribers and the number of shares to which each subscribes.***

9. Names and addresses of persons who will serve as directors until the first meeting of stockholders or until their successors are elected and qualify.

Fee or Organization Tax Charged for Incorporation

The fee charged for incorporation varies greatly As an example, the incorporation fees charged by two different States are listed below:

State A
Minimum charge $10
Par value shares:
  10¢ per $1,000 up to $2,000,000
  5¢ per $1,000 from $2,000,000 to $20,000,000
  2¢ per $1,000 over $20,000,000
No-par value stock:
  1/2¢ per share up to 20,000 shares
  1/4¢ per share from 20,000 to 2,000,000 shares
  1/5¢ per share over 2,000,000 shares
Filing and indexing certificate of incorporation: $2
Recording fee:
  $4 for the first 1600 words or less
  75¢ for each additional page
  50¢ for certificate that charter has been recorded
Certifying copy: At least $5
Stock ledger and transfer book: $7

State B
Minimum fee $50; maximum fee $2,500
Par value shares:
  $50 for first $10,000 or less of capital stock
  $10 for each additional $10,000 or fraction thereof
No-par value stock:
  $50 for first $10,000 actual consideration for which shares have been issued
  $10 for each additional $10,000 or fraction thereof actual consideration for which shares have been issued

(In computing this fee, no-par value shares which have not been subscribed to or paid for shall be assumed to have the same value per share as those shares already sold.)

Certifying copy: (15¢ per folio and $1 for certificate)

Total: About $2.

FOR FURTHER INFORMATION

Businessmen who wish to explore further the subject of incorporating a business may be interested in the references listed below. In keeping with the editorial policy of the series, this list has been kept brief and selective. However, no slight is intended towards authors whose works are not included.

Business Management Handbook, by J. K. Lasser (chapter I, "How to Find the Right Form For Your Business"). McGraw-Hill Book Company, Inc., 330 W. 42nd Street, New York 36, N. Y. 1954. $9.75.

Corporations in the Farm Business, by N. G. P. Krausz and Fred L. Mann. (Circular 797, supplement March 1959 describes 1958 revision in the tax law, Technical Amendments Act of 1958. Although written primarily for farmers, much of the discussion is applicable to the small businessman. Advantages and disadvantages of incorporation, how to incorporate, how to operate a corporation.) College of Agriculture, University of Illinois, Urbana, Ill. June 1958.

"Incorporate and Elect Subchapter S? Pros and Cons for Proprietors, Partners," by Arthur B. Willis. (New tax effects of incorporation as provided by the Technical Amendments Act of 1958.) In *Journal of Taxation*, Journal of Taxation, Inc., 320 North Sixth Street, Paterson 2, New Jersey. Aug. 1959. $1.50.

Organizational Problems of Small Businesses, by Leonard Sarner. (Includes chapters on "Selection of the Proper Form of Business Enterprise," "Molding the Business Organization," and "Tax Consequences.") Revised by Howell C. Mette. Committee on Continuing Legal Education of the American Law Institute, 133 South 36th Street, Philadelphia 4, Pa. 1956. $2.50.

Organizing Corporate and Other Business Enterprises, by Chester Rohrlich, 3rd ed. Matthew Bender and Company, 255 Orange Street, Albany 1, N. Y. 1958. $15.00.

SMALL BUSINESS ADMINISTRATION
Management Aids for Small Manufacturers
Washington 25, D. C.

SELECTING A LAWYER FOR YOUR BUSINESS

By *Theodore Voorhees*, partner in the firm of Barnes, Dechert, Price, Myers and Rhoads, Philadelphia, Pa.

SUMMARY

Every business needs legal advice from time to time. There are, after all, many fields of business activities in which the services of lawyers may prove essential. Reliance on the assistance of persons lacking legal training may prove costly in the long run.

Because a lawyer or law firm can be a tremendous asset to any organization, the selection of counsel should be made with great care: Counsel should only be engaged after a thorough, intelligent appraisal of his capability and potential value to your concern. You should try to find the lawyer or law firm best equipped to render service to the particular needs of *your* business.

This Aid discusses several criteria for the selection of counsel and certain steps to be taken in securing legal representation. It points out that you have a choice between general practitioners and law firms, the latter usually containing specialists in various fields of law.

Legal services cost money, of course, but *preventive legal advice* is inexpensive when compared to the cost of law suits which may result from the failure to seek out competent legal advice.

THE NEED FOR LEGAL REPRESENTATION

Hiring a lawyer is an important task. This article will give you some suggestions on how to go about it. But a word of warning is in order. Some of the steps advocated here may not be appropriate for *you*. The reason for that qualification is this: Certain aspects of the preliminary investigation of a law firm and its members simply are not feasible for most very small business owners. In some situations, lawyers may refuse to tell a businessman all he wants to know. Some law firms, moreover, may not want to handle the kind of case proposed at all. Still, you *can* ask various questions and expect to get answers on them – including the fees charged by the lawyer or law firm you intend to hire.

Before you undertake to retain a lawyer or a law firm to handle your company's legal affairs, you should have in mind the various fields of business activities in which the services of a lawyer would prove helpful. Six rather general areas should be explored.

First, if your business is incorporated, you may need advice regarding directors and stockholders meetings, dividends, rights of stockholders, and the like.

Secondly, relationships with employees may require legal services in labor negotiations, proceedings before the National Labor Relations Board and boards of arbitration, and all other matters involving industrial relations.

Thirdly, problems may arise within the trade wherein you may need advice with respect to anti-trust violations by your company's suppliers or Robinson-Patman Act questions in connection with sales to the customers of your concern. This highly technical and little understood field of Government regulation becomes more important from year to year.

Fourthly, the company may encounter difficulties in its relations with the public, of which the most common are collection claims and claims for personal injury, property damage and product liability. Somewhat less frequent are claims for libel, slander, defamation, false arrest and malicious prosecution.

Fifth, the legal problems of taxation, Federal, State and local, are faced almost daily by all business concerns.

Finally, there are other highly specialized fields of legal advice such as those of patent, copyright and trade mark, Security and Exchange Commission financing and practice before governmental agencies such as the Federal Power Commission and the Interstate Commerce Commission.

LEGAL ADVICE FROM OTHERS THAN LAWYERS

Many people will tell you that there is no need for a lawyer's advice in connection with any or all of the foregoing. This is a dangerous fallacy.

• ***Ask Lawyers About the Law.*** It is against the law for any person who lacks legal education and training to engage in the practice of law. However, an astonishing number of seemingly intelligent people act on the advice of non-legally trained individuals on matters involving questions of law. The unlawful practitioner, no matter how honest and well-intentioned he may be, is apt to cause serious grief. He is not trained to perceive legal problems, and he cannot be aware of all the legal implications of his words. Preventive legal advice is inexpensive. But the cost of litigation, which would have been unnecessary had that advice been obtained earlier, can be very high.

THE CHOICE OF A LAWYER OR A LAW FIRM

Most business concerns in search of legal representation will find that three choices are open to them:

First is the general practitioner who maintains a law office by himself, or with one or two younger associates. Second is the small firm having several lawyers practicing together. Third is the larger law firm, which may have from around a dozen lawyers to as many as 100 in a few instances.

• ***Making a Basic Choice.*** Assuming that your company is looking for high quality, the first basic question which you will face, therefore, is whether you wish to be represented by a general practitioner capable of advising you on all legal problems and giving you representation in court, or whether you would be better off with a firm of lawyers who may have more specialized training and services to offer.

It should be said at the outset that all lawyers today, as part of their legal education, receive training in all the major branches of the law. That training, in the case of many who practice by themselves or with one or two younger associates, may be supplemented by broad experience in the course of years of practice. A lawyer who is a general practitioner is qualified to provide advice in connection with a great variety of legal questions.

• ***Legal Specialists.*** The law, however, has become extremely complex, and many lawyers have ceased to engage in a general practice and are devoting their entire efforts to one or more narrow fields in which they become specialists. Large and small firms of attorneys have tended to include groups of experts who supplement each other's special skills. Thus, a typical small law office with six or eight attorneys may have one lawyer specializing in general corporate management, another in labor matters, a third in courtroom work, and a fourth in taxation problems. If the office is a little larger, it may have specialists on antitrust problems, personal injury cases, unfair competition, product liability, and administrative agency practice, as well.

• ***A Word About Costs.*** You will want to know, of course, whether your legal costs will be higher if you hire a law firm than they would be if you hired a lawyer practicing by himself. Unfortunately, no generalization can safely be made. There are both firms and individual lawyers whose charges are low. There are also those whose charges are comparatively high. It may be said, however, that in the case of the top-notch lawyer or law firm, charges for legal services reflect the opinion of counsel and client as to what those services are worth. As in the case of the seller of any commodity, a lawyer will not long be successful in obtaining clients if his charges are out of line with respect to his legal talents. The cost of legal services should not be the chief element in the choice of legal counsel. Good advice will save you money, and you will find that most lawyers will adjust their fees if there is dissatisfaction on the part of the client.

Of course, the selection of counsel may be narrowed down by conditions in a given locality. For example, in the smaller town or city your choice of counsel may be solely between the general practitioners and perhaps a few small firms. In such case, you may decide to rely upon a local lawyer for your routine legal questions and seek out the advice of specialists in a neighboring town or city if and when the need for more specialized service should arise.

Most business concerns will find that they have a broader choice of attorneys to represent them, and a few pointers may be given as to the differences between the three types of practitioners.

THE GENERAL PRACTITIONER

The choice of an independent, general practitioner, who is wholly on his own or has one or two associates to assist him, has the great advantage of providing you with a lawyer who at all times will be familiar with your company's principal affairs. You will deal with one man only, and there will be no division of responsibility. Also, you will be able to appraise his potentialities quickly for he is likely to be well known in the community. The possibility of conflicting interests is probably remote, for you are dealing with only one man and his existing legal relationships.

Many business concerns, large as well as small, are satisfied to place all their legal affairs in the hands of a single attorney. But in particular cases, the general practitioner may be on an unequal footing when he has to oppose a legal specialist.

When the general practitioner is on vacation, or becomes ill, or is compelled to expend substantial time on the affairs of his other clients, you may be temporarily without the protection of legal advice. His death may cause grave hardship, since there may be no one else to carry on his work.

THE SMALL FIRM

The law firm with several lawyers practicing together, has the advantage of enabling you to maintain close personal relations with your counsel since the number of attorneys with whom you will deal is relatively small. Such a firm may provide specialists in the key areas of your interest. In many of them you will find specialists in trial work, taxation, corporation law, and perhaps several others. The retention of such a firm, however, presents this feature, when compared to the lone practitioner: It involves at least *some* division of responsibility. As compared with the large office, it is, of course, generally not in a position to give the range of specialization which the latter has to offer. However, you may find that it is equipped to take care of your basic needs for legal service.

THE LARGE FIRM

The large law office's chief advantage may be ascribed to its quality of depth. It does not merely have specialists in a large number of fields, but has men of different ages and experience in each area whose services may be adapted to the varying needs of the client. Of course, conditions in a large firm can tend to dilute the personal relationships between the officials of your company and its counsel. And there may be, unless carefully watched, a division of primary responsibility, too.

Obviously, just as a small law firm has a broader clientele than a single practitioner, a larger firm is apt to have considerably more clients than a smaller one. The greater breadth of its contact and experience may constitute an advantage to you. Whether you deal with a general practitioner or a law firm you may find that lawyers, in addition to their purely legal activities, may become important intermediaries in transactions of a strictly business nature.

LEGAL QUALIFICATIONS

Before discussing the actual process of the creation of a lawyer-client relationship, mention should be made of several other criteria for selection, which should assist you in making your choice.

• ***The Counsel You Want.*** Essentially, of course, you are looking for proven legal ability and experience. It should not be difficult for you to find out whether your candidate has these primary qualities; and you should seek a man who will furnish prompt and efficient service, will speak plain language and charge fair fees.

He should have true stature in your community and before the courts. If that stature is present, it will surely mean that there exist with it the highest standards of legal ethics. If you should retain counsel who did not have such high standards, you would be likely to find that the reputation of your company might well suffer in the eyes of your community.

One further guidepost should be mentioned if you are considering the employment of a law firm. You would be wise to look for balance between youth and age in the firm. There is nothing which strengthens and improves a law firm more than a program, steadfastly adhered to, of infusing new and youthful blood.

PRELIMINARY INQUIRY

Before you establish a client-attorney relationship, it goes without saying that you will want to make a careful inquiry about the lawyer or firm of your choice. You should not take on the first man whose name is mentioned, or employ a man merely because he is the friend of someone you know.

• ***Where to Seek Advice.*** There are a number of people whose advice can be of value. Perhaps your first questions should be directed to your banker, public accountant or auditor, all of whom have many dealings with lawyers and are familiar with your business and your needs. Do not hesitate to inquire at the courthouse about the status of your prospect. You should, of course, talk to business friends whose discretion is to be trusted, and if there are any lawyers who are disqualified from being your counsel because of conflicting interests you might even want to seek their advice.

PERSONAL INTERVIEW

When you are satisfied that you have learned enough about the general practitioners or law firms of your community, telephone the man of your choice or the head of the firm you have chosen, and ask him if you may call upon him at his office. (The impression which the law office itself may make upon you may well be an important factor in the making of your selection.)

• ***Questions to Ask.*** If you get an interview with a member of a law firm, don't hesitate to ask him about the age, education, legal qualifications and experience of those practicing in his office who might handle the work of your company. You ought to tell him a little about your business set-up, and he should explain what specialists his office has who might prove of service to you. You are entitled to know who the principal clients of the law office are (so as to make sure that it represents no one whose interests conflict with yours), how broad is the firm's practice and how wide its experience. You will want to know how well the office is equipped, time wise, to represent you. Time is the lawyer's most important stock in trade. If he or his office is not busy, you should be cautious and get more information about him from other sources. If he is very busy, you will want to make certain that your problems will not find themselves on the rear burners of any legal stove.

• ***Hiring a Law Firm.*** If you intend to hire a law firm, there are two key questions that you should ask at your initial interview. First, how is the work allocated as between partners and associates, and between the younger and older men? This is of vital concern to you because you will pay a good deal more for the services of senior partners than for those of junior partners, and more for the latter than for the work of the junior associates.

Second, you are entitled to know from the beginning how the law firm handles the question of fees. Most well-managed law offices follow sound principles of cost accounting and base fees upon the amount of time devoted to the particular work. You are entitled to know what sort of time records they keep (and whether they will show them to you when you are billed). They may not be willing to have you pin them down on precise hourly rates charged by senior partners of the firm, but they may be willing to give you the range of rates charged for the work of younger partners and associates.

Such a discussion is a delicate one. But both you and the law firm will remain on more comfortable terms if this matter is placed on a businesslike basis from the very beginning.

THE DIVISION OF YOUR WORK

As it becomes evident that you are seriously considering retaining the lawyer whom you have sought out, he (if he is a member of a firm) should want you to meet other lawyers in his office. Of course, if he is a member of a large firm he may pick out only a few of his key partners, but they should be the members of his staff most likely to do the work of your company. Do not shy away from the suggestion that a number of different men may handle various aspects of your work. On the contrary, if you are going to retain a law firm, you should make the most of the opportunity to get the specialized knowledge of the lawyers in it.

- ***Building Teamwork.*** Obviously, if you do employ a firm the relationship between your executives and the various lawyers in that firm who may handle your work cannot be fully developed at the time of your first contact with the law office. That will be worked out over a period of time. You will be wise to ask the law firm to designate one man who will have the general responsibility for the legal work performed for your company and who will be, in effect, your contact man. There would normally be no reason why the senior partner of the firm either should or should not be that man, but in the beginning some businessmen feel more comfortable relying upon him.

- ***Who Should Do Your Legal Work?*** The law firm itself is generally best able to judge how your work should be allocated. However, it is *your* organization that has to be satisfied, and you are entitled to be heard on the subject. After you have had some experience with the firm, you should rapidly lose any feeling that all of your work should be taken to the senior partner level. You will probably want to rely on a senior partner for advice on questions of major importance. He may be the man who should appear for you in court. He should be your legal spokesman. But the bulk of your legal work can certainly be performed at lower levels.

REPRESENTATION ON A FINAL BASIS

If you are satisfied with the results of your initial discussion, you may suggest that your selected counsel undertake to do some legal work for you on an introductory or trial basis. He should not be offended by the suggestion and may, in fact, welcome it. He may know less about you than you do about him, and he may have some reservations about undertaking to represent you on a permanent or full-fledged basis. Obviously, if you are not altogether pleased with the results, you should start to review other possibilities before becoming too heavily involved with your first choice.

SMALL BUSINESS ADMINISTRATION

Management Aids for Small Manufacturers

Washington 25, D. C.

RATING YOUR FIRM'S ORGANIZATION

By *Erich M. Hauer,* Management Consultant, Forest Hills, N. Y.

SUMMARY

Organization is something small business operators are currently hearing a lot about. The term crops up constantly in the business and industrial press. To some plant owners it may sound like big business exclusively. But actually it isn't - - or shouldn't be. The organizational setup deserves close attention in any concern made up of two or more people. Good or bad, it exists in all but the single-man firms. To rate your firm's organization, read the following statements. After each, check as objectively as you can the response which best fits conditions in your firm.

	NO	YES
1. The term "organization" has real meaning in your firm.	☐	☐
2. Basic company policies are clearly stated in writing.	☐	☐
3. Duties and responsibilities are spelled out in detail.	☐	☐
4. Personal characteristics have been taken into account.	☐	☐
5. Standard operating procedures have been established.	☐	☐
6. Each man has just one boss.	☐	☐
7. Organization relationships are charted on paper.	☐	☐
8. Actual company conditions are recognized and reflected in the organization chart.	☐	☐
9. The top man operates within the organization framework.	☐	☐
10. Organization structure is reviewed periodically.	☐	☐

Now give yourself 10 points for each "yes" box checked. A score of 80 and over is good, 70 to 40 is fair, and 30 or less shows a real need for improvement. Finally, after reading the whole Aid, re-check your answers and see if your rating would be the same.

The only business that does not need a clearly-defined organizational setup is a one-man business. Yet poor organization is all too common today in scores of businesses ranging from 5 to 500 employees.

"A formal organization," said one owner, "may be of value to some companies, but we are just different enough that we don't need it." That belief, however, has prevented many a potentially excellent profit-maker from staying competitive.

The typical small concern is usually a fairly accurate reflection of its owner-manager. Generally speaking, a cluttered desk in the owner's office, constant telephone interruptions, and all kinds of decisions being sought by everybody, evidences a lack of organization. Most of the time the reverse is also true. A clean or well-ordered desk, consultation chiefly with supervisors on important points (still keeping some personal touch), and the willingness to delegate in fact not just in theory, bespeak good organization.

DOES "ORGANIZATION" MEAN SOMETHING IN YOUR FIRM?

Organization is the executive structure of a business and the interrelationship of its members. It is made up of people. That's where many of the problems develop. If it were as easy to deal with people as it is to manipulate machinery or materials, a definition of activities and lines of communications would be all you'd need. In management something more is necessary.

To illustrate: a midwest food processor got into financial difficulty. It was not a question of the partners' lack of effort, or of excessive pay. The trouble lay in purchasing. There was a chronic lack of cash caused by the fact that the partner in charge of purchasing wanted to assert his independence. Consequently, he bought whatever he wanted, whenever he thought he had a good buy. What was needed was a coordinated policy.

DO YOU HAVE A CLEAR POLICY STATEMENT?

A sound organization needs a clear statement of policy. The limitations and definitions of business aims are essential. Your statement need not be elaborate, nor do you have to have it in a specific form. It does have to be thought out and written down.

First, the basic aim of your business should be defined - - usually it is providing a product or filling a need. Then you should specify what you want out of your business: to reach a certain size and remain there, or to aim for constant growth and diversification; to make a comfortable living for yourself or to establish a business that your heirs can carry on; to operate as a proprietorship or a partnership, or a corporation; and so on.

ARE JOB ASSIGNMENTS SPELLED OUT?

Once your basic policy has been set, you need a detailed written description of the assignments of executives and key people. This is one of the most important steps, if not the most important one, in keeping a business going. Each employee and supervisor, should know specifically: (1) what his job is supposed to accomplish; (2) what his duties are; (3) what authority he has; (4) who his boss is; (5) who reports to him; and, (6) what constitutes satisfactory performance.

This does *not* mean that you should tell your executives how to do their jobs - - looking over their shoulders, as it were, and telling them: "Play the queen on the king." It *does* mean giving them a framework in which to operate and some direction for their efforts. Unless these things are plainly spelled out, and understood by the individuals involved, there can be no organization.

HAVE YOU STUDIED YOUR EXECUTIVES AS PEOPLE?

For a good organization you also need to know more about your associates than you find out just by watching what they do. Building a team requires an understanding not only of the sort of work individuals *are now doing,* but also of what they *can do* and *want to do.* It is therefore, important to enquire into the aptitudes, aspirations, interests, and values of your people. The best way of learning about these things is psychological testing. Professional help is important in this work because the layman is not usually qualified to determine which of the many available tests are appropriate, nor to interpret test results properly and draw reliable conclusions from them.

HAVE YOU ESTABLISHED STANDARD PROCEDURES?

Next, you need to develop a clear statement of how things are to be done. The degree of detail and the exact wording, of course, must be worked out for the individual business. However, the following points are worth covering.

(1) *Use of procedures.* In this connection, it should be indicated that "standard procedures are for the guidance of all concerned."

(2) *Changes in procedures.* You might point out that "procedures are in effect now, but can be changed for good reason. However, until they are changed they must guide your actions. The following persons have authority to depart from them in exceptional cases: I. Mr. . . . . ; II. Mr. . . . .;" and so on.

(3) *Specific instructions and rules.* These might include: "All purchases over $ __________ have to be approved by Mr. ______________ . For lesser amounts only the signature of Mr. __________ is needed on the purchase request;" or, "Partial shipments of less than 25 pieces need the approval of Mr. __________ ;" and so on until all regular executive responsibilities and standard routines have been covered.

In many instances, the details of item (3) above can be developed piecemeal over a period of time, but a statement of the basic procedures is a prerequisite of good organization.

DOES EACH MAN HAVE JUST ONE BOSS?

For generations there has been the concept that "man cannot serve two masters . . ." It is applicable in modern conditions. The motorist who is hounded by conflicting directions from back-seat drivers finally may pull over to the curb, throw up his hands, and walk away. In comparable situations in business an employee is sometimes held to his job by economic necessity. He doesn't walk away physically, but he does mentally. He loses interest in the job and his efficiency drops.

Therefore, it is important to make sure that each man has just one boss to whom he reports and from whom he receives instructions. To be sure, there are situations where a man works part of the time in one department and part of the time in another. If it is clearly understood by all when he works for the one and when for the other, the arrangement can work. The key to it is that the man has only one boss *at a time.*

IS YOUR ORGANIZATION CHARTED ON PAPER?

Even a very small plant needs an organization chart showing the duties and relationships of each activity. Many businesses, however, attempt to operate without this formal chart. By the same line of reasoning, these concerns would move to a new location without planning where each piece of equipment was to go, or seeing to it that there were enough electrical outlets.

An organization chart showing, graphically, the relationships of your executive group, and the duties and authorities of your supervisors is important. Such a chart is the sole means by which you can get a quick, overall picture of your management team.

This fact calls to mind a concern that went bankrupt. This firm, a plastics fabricator, was bought out by two former employees after the death of the founder. One of the new owners had been production manager, the other a salesman. They knew their field well and were competent in their jobs. Each had known the other for some time; both wanted to make a success of this enterprise. Indeed, from their point of view they *had* to. All their money was tied up in the venture.

They failed, however, to set forth in detail what their respective new assignments were to be, and what details each was to take care of. The salesman considered sales his only responsibility. In fact, he spent almost no time in the office. Since the salesman was never available, the production man had to spend more and more hours on the telephone answering customer questions and inquiries. Growing friction between the two finally caused the production man to buy out the salesman.

Since there was no ready cash, it was agreed that the salesman should be paid a stipulated, monthly amount. This monthly cash drain, plus the fact that the production man then had to handle everything including sales, proved too much for the firm. Today it no longer exists. The real cause of the collapse of this business was the lack of organization at the top level.

ARE ACTUAL CONDITIONS RECOGNIZED?

Before you can judge your organization conclusively, you must get a clear picture of how it is *actually* working. Take, for example, your organization chart. The initial version may be a somewhat idealistic picture.

To bring it into agreement with real-life conditions, begin by listing the names of all employees, followed by their titles and duties. Then group together under their immediate supervisors the employees having the lowest common grade. This gives you the two bottom lines of your organization chart. On the next line above you can post the names of the individuals who supervise more than one group. Follow this approach successively until you get to the top. You may come across some boderline cases where a person might belong to more than one group. But since this is the initial step, precise placing within groups, especially in the lower lines, is not critical.

The next step is to ask your employees to write down six items of information. In small concerns of, say, 50 people or less this is quite feasible. But should your firm have too many to do so all at once, you might have it done by section or department. The six items are:

(1) What he does, including the average amount of time spent during a week on each duty;

(2) The names and titles of the person or persons from whom he gets orders or instructions on each of the above-listed duties;

(3) What suggestions and advice he gives and receives;

(4) What reports he writes (if any) and who gets copies;

(5) What reports (if any) he receives, from whom, and how the information is used; and

(6) Any other factors which are important in his job.

Emphasize that your purpose in making this study is not to down-grade anybody or eliminate any jobs, but rather to assure that the efforts of every person be put to best use and, in the long run, to benefit everyone.

After you have received these reports, sit down briefly with each person and discuss his write-up to make sure that no applicable item is left out, and that no inappropriate item was added.

After analyzing the write-ups you will be able to see where the initial chart is only an approximation of your true management organization. You may find unsuspected lines of communication between departments and between individuals. That fact in itself is not bad, but it does mean that you need to revise either your organization or your chart. Only in this way can you determine how far your actual organization conforms to what you think it should be. Naturally, you must apply good common sense to "what you think it should be."

DOES THE TOP MAN OPERATE WITHIN THE ORGANIZATION FRAMEWORK?

Effective organization develops from the top down. It has to start with the boss. If he refuses to "play by the rules" he has set up for the business, others will soon have little respect for them.

Therefore, it is essential that the chief executive know the organizational set-up, that he act in accordance with its relationships and procedures, and that he insist that others do so, too.

Employees, supervisors, and executives in most businesses, even where there is transient labor, are eager for less but better supervision. Almost everyone wants to do a good job and turn in an honest day's work. However, it is unfortunately true that management often holds people back. Much of the time, complaints in small business about shortages of money, sales falling off, excessive personnel turnover, and similar difficulties can be traced to poor organization for which the top man can blame only himself.

DO YOU REVIEW ORGANIZATION STRUCTURE PERIODICALLY?

In small business management, organization means people in actual jobs. It is simply a method of trying to set up the most productive relationships of individuals and tasks. In time, both elements change. Therefore, make sure that you have some provision for reviewing your organization periodically - - say, once every 6 months or each year. Where conditions have changed, revisions should be made sooner These should be worked out carefully and put into effect quickly. An organization plan which has become a strait jacket can be worse than having no plan at all.

FOR FURTHER INFORMATION

Businessmen interested in exploring further the subject of organization may wish to consult the books mentioned below. Other publications, of course, are available; however, in keeping with the editorial policy of the series, this list is necessarily brief and selective. No slight is intended towards authors whose works are not included.

Psychology of Management, by Mason Haire. McGraw-Hill Book Company, 330 W. 42nd St., New York 36, N. Y. 1956. $4.75.

Problems of the Independent Businessman, by Austin Grimshaw. McGraw-Hill Book Company, 330 West 42nd Street, New York 36, New York. 1955. $6.50.

The Small Manufacturer and His Specialized Staff, by D. R. G. Cowan. Small Business Administration. 1954. Available from Superintendent of Documents, Washington 25, D. C. 20 cents.

Planning and Developing the Company Organization Structure. Research Report No. 20. American Management Association, 1515 Broadway, New York 36, New York. 1954. $4.75.

Business Policy, by C. L. Jamison. Prentice-Hall, Inc., Englewood Cliffs, New Jersey. 1953. $6.50.

Business Organization and Practice (2nd Ed.), by E. S. Robinson. McGraw-Hill Book Company, 330 West 42nd Street, New York 36, New York. 1953. $5.

Management Succession in Small and Growing Enterprises, by C. R. Christensen. Harvard Business School Division of Research, Boston 63, Massachusetts. 1953. $3.25.

Leading and Managing Men, by D. C. Lynch. The Ronald Press Company, 15 East 26th Street, New York 10, New York. 1950. $3.

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency
Management Aids FOR SMALL MANUFACTURERS 80

Washington, D.C.

CHOOSING THE LEGAL STRUCTURE FOR YOUR FIRM

By *Edward L. Anthony*, formerly Chief, Publications Division, Small Business Administration, and the late *A. Barr Comstock*, formerly Special Assistant to the Attorney General

SUMMARY

A growing number of small business owners are taking a new look at the legal structure of their firms. Many individual proprietors are wondering if they would be better off with a different set up. They aren't sure. They'd like more information, but haven't time to do research. And before consulting a lawyer on the matter they want some background knowledge as a basis for discussion. One man put it this way: "Without boning up on partnerships and corporations, I wouldn't even know what questions to ask." Therefore, to meet the need for a brief, general picture of what the different legal structures involve, this Aid has been prepared.

In addition to the tax situation, six other points are suggested as significant in sizing up legal structure: costs and procedures in starting, size of risk, continuity of operations, adaptability of administration, influences of applicable laws, and attraction of additional capital. Three main types of structure are analyzed: single proprietorships, partnerships, and corporations. Other forms such as syndicates, joint stock companies, Massachusetts trusts, and pools are not discussed because being specialized and rare, they are of less interest to most small business owners.

If a small concern is to operate effectively in today's climate and continue to exist when the present owners can no longer function, its legal structure must be right. For this reason, many small business operators ask: "Should a proprietorship be continued? Would partnership be better? What about incorporation?"

JOE PORTER'S PROBLEM

Take, for instance, the case of Joe Porter. In 1945, Joe took his wartime savings, a chunk of his wife's nest egg, and a loan from his bank and started a small plastics molding business. He learned fast, worked long hours, and got some good breaks. Today, he owns an up-to-date little factory with good equipment, 97 employees, and annual sales of $940,000.

Until lately, Joe had not been interested in making any changes in the legal structure of his firm. He enjoyed being sole owner. He liked being able to make independent decisions and felt that there was really no need to risk "upsetting the apple cart" by revamping his organization.

Nevertheless, Joe listened carefully when his accountant brought up the effects of sticking to the status quo. For one thing, tax considerations backed up the point. For 1964, Joe's firm made a net profit of $47,000. His personal and family expense had totalled $14,000. All the same, he had to pay personal income tax on the entire business profit. He reported his income on the calendar year basis and filed a joint income tax return with his wife. After subtracting $4,000 for exemptions and deductions, he reported $43,000 on which he paid $14,415 tax. However, if the firm had been a corporation which reported its income on the calendar year basis and he had taken, say, a $17,000 salary, his tax bill would have looked like this:

(1) Personal income tax on $17,000 salary (less $4,000 exemptions and deductions)	$ 2,690
(2) Corporate taxes on the net profit (after salary) of $30,000:	
22% on $30,000........	6,600
28% on 5,000........	1,400
(3) Total tax......................	$10,690

Thus if the company had been incorporated, Joe would have saved $3,725 in taxes for last year alone. That, said the accountant, seemed worthwhile. Moreover, there would have been no objections from the Internal Revenue Service to a $17,000 salary for the president of a business the size of Joe's. Plenty of comparable executives got as much or more for services they actually performed.

With these facts in mind, Joe asked his lawyer for a fill-in on legal structure in general so that he could better decide whether he should go further in making changes in his company's set up.

THREE MAIN CHOICES

Broadly speaking, the lawyer said, there are three principal kinds of business:

- *Proprietorship* which is the easiest to begin and end (sometimes prematurely), can have the most flexible purpose for its operations, needs no Government approval, has business profits taxed as personal income, and makes the owner personally liable for debts and taxes.
- *Partnership* which is the simplest for two or more people to start and terminate, has the same flexibility of objective, has partners taxed separately, and makes personally liable for debts and taxes all except limited partners.
- *Corporation* which is the most formal of structures, operates under State laws, has continuous and separate legal life, has its scope of activity and name restricted by a charter, has the business' profits taxed separately from earnings of executives and owners, and makes only the company (not the owners nor managers) liable for its debts and taxes.

(There are other types of legal structure such as syndicates, joint stock companies, Massachusetts trusts, and pools, the lawyer pointed out. However, these are specialized and rare. For that reason they are eliminated from this discussion.)

SIX POINTS TO CHECK

In analyzing your own situation, it pays to go to the expense of getting advice and guidance from competent legal counsel. Great care should be taken to make the right decision the first time. Among other things the lawyer pointed out, it is worthwhile for the top executive to be familiar with the highlights of six main points on legal structure in addition to tax considerations: (1) Costs and procedures in starting; (2) size of risk--that is, amount of investors' liability for debts and taxes; (3) continuity of the concern; (4) adaptability of administration; (5) influences of applicable laws; and (6) attraction of additional capital.

1. Costs and Procedures in Starting

Single proprietorships are the easiest to get started. The costs of formation are low. Basically all you have to do is find out whether you need a license to carry on your particular business, and whether you have to pay a State tax or license fee.

General partnerships are also started quite simply. You can set one up by having the executives in the business sign what is called a partnership agreement. A written document, however, is not necessarily a prerequisite, since an oral agreement can be equally effective. Moreover, a partnership may even be implied by actions which the managers of an unincorporated business have taken--even though no agreement of any kind, oral or written, exists.

Limited partnerships are somewhat more difficult to set up. To form one you file with the proper State official, a written contract drawn according to certain legal requirements. This contract permits you to limit the liability of one or more of the partners to just the amount which they invested. But you must designate at least one general partner in addition to the limited partners. And all limited partners must have actually invested in the partnership. According to the Uniform Limited Partnership Act, those investments may be either cash or tangible property, but not services. Lastly, you must conform strictly to the laws of the particular State in which you organize; otherwise your business will be considered as a general partnership.

Corporations are more complicated to form than any of the other types of organization. You can create one only by following strictly the legal procedures of the particular State in which the corporation is being set up. First, certain responsible people are needed to organize and become officials in the new corporation. Next they must file with the designated State official a special document called the "articles of incorporation." Then they must pay an initial tax and certain filing fees. And finally, in order to do the business for which the corporation was formed, various official meetings must be conducted to deal with specified details of organization and operation.

2. The Size of the Risk

The degree to which investors in your enterprise risk legal liability for the debts of the business is a cardinal consideration. Regardless of legal structure, creditors are always entitled to be paid out of business assets before any equity capital may be withdrawn. In cases where those assets are insufficient, the extent to which owners can be compelled to meet creditors' claims out of their own pockets varies with the type of organization.

A single proprietor is personally liable for all debts of his business--to the extent of his entire property. He cannot restrict his liability in any way. Likewise, each member of a *general partnership* is, himself, fully responsible for all debts owed by his partnership--irrespective of the amount of his own investment in the business. In a *limited partnership*, however, the limited partners are protected; they risk only the loss of the capital they have invested. But the general partners in a limited partnership are liable jointly and severally for all debts just like any other general partner. And remember, there must be at least one general partner in any limited partnership.

Corporations have a real advantage, as far as risk goes, over other legal structures. Creditors can force payment on their claims only to the limit of the company's assets. Thus while a shareholder may lose the money he put into the company, he cannot be forced to contribute additional funds out of his own pocket to meet business debts. This is true even though the corporate assets may be insufficient to meet creditors' claims.

3. Continuity of the Concern

In choosing the legal structure for your business, you should also understand clearly how it influences the continuity of the business. Although *single proprietorships* have no time limit on them by law, they are not fundamentally perpetual. Illness of the owner may derange the business and his death ends it. *Partnerships* are perishable in the same general sense--since they are terminated by the death or withdrawal of any one of the partners.

Corporations have the most permanent legal structure of all. They have a separate continuous life of their own. The withdrawal, insolvency, injury, illness, or death of a person officially concerned in a corporation does not mean its finish. Moreover, the certificates of stock, which represent investments and ownership in the business, may be transferred from one person to another without hampering the concern's operations.

4. Adaptability of Administration

In the *single proprietorship*, policy and operations rest, of course, in one individual. This situation can be both good and bad. On the one hand, concentration of management avoids the problems of opposing factions and divided responsibilities. The fact that the chief executive is in full charge, and is in complete control of profits, can be an incentive to careful management. On the other hand, many a man is not competent to handle all management jobs himself. To be sure, an owner can, and often does, employ assistants to whom he assigns various details. But he still reaps the rewards or the penalties of what they do. It is also worth noting that after incorporating, the owner of a small business does not necessarily lose control of the enterprise. In many small, closely held corporations, the former sole owner can and often does retain control by the ownership of a majority of the stock in the newly formed corporation.

In *general partnerships*, each partner typically has an equal role in administration, with the various operating functions divided among them. The combined abilities and knowledge of several executives gives the partnership an advantage over the single proprietorship. But the division of functional responsibility among the several partners may lead to fundamental policy disagreements. When you compare them with corporations, partnerships have the following administrative features: Decisions may be taken and changes adopted simply by oral agreement among the partners. In limited partnerships, the limited partners may not engage in management functions; if they do, they may be held fully liable as general partners. They are, however, entitled to inspect the books and obtain full and complete information regarding the business.

In *corporations*, the stockholders do not necessarily participate either in operations or in policy formulation, but they may. Often, however, those functions are centralized in a relatively small group of executives who own only a small percentage of the shares. Although corporations can get away from the shortcomings of the limited ability or knowledge of one person, they do run some risk of inefficient management where those in control have little or no direct financial interest. Corporations have an advantage over partnerships in this way: In partnerships each partner can act as general agent for the business; but in corporations, the stockholders cannot bind the firm by their acts just because they have invested capital in it.

5. Influences of Applicable Laws

Single proprietorship is the oldest and most widespread legal structure of business. As a result, little doubt remains as to the influences of laws regulating its legal rights and obligations. Likewise the relationships are clear between a sole owner, his agents, his creditors, and others with whom he deals in business. A private citizen working in Iowa, can carry on business in Kansas without paying any greater taxes or incurring any more obligations in Kansas than local Kansas businessmen have.

Broadly speaking, this same situation is also true for a *partnership*. Of course, a State may require the purchase of a license to carry on a particular kind of business. But the license will be equally available to businessmen of any State so long as they conform to prescribed uniform standards. (This equality of opportunity derives from the United

States Constitution which guarantees to citizens of each State "all privileges and immunities" provided to citizens of the other States.) Thus, the legal structures which do not involve any artificial entity (as a corporation does) provide a freedom of action in all States which corporations cannot match.

Corporations owe their legal life solely to the States in which they are organized. No other State is required to recognize them. To be sure, all States do permit out-of-State corporations to function inside their boundaries. Nevertheless, out-of-State corporations must always comply with special in-State obligations such as (1) filing certain legal papers with the proper State officials; (2) appointment of a representative in the State to act as agent in serving process on the "foreign" corporation; and (3) payment of specified fees and taxes.

Also, corporations are regulated by numerous State laws which vary considerably. Even when the language is similar, these laws can be, and have been, interpreted differently in different places. Therefore, in running a corporation effectively, competent legal counsel is virtually indispensable. The normal course of business, for example, can easily involve statutes and court decisions of a State other than the one where the corporation was founded. Nevertheless, the essential feature of limited liability of stockholders is preserved in every State.

6. Attraction of Additional Capital

Every business may require additional funds from time to time to carry on operations. And if it can't obtain adequate capital, it may well be headed for failure. It is important, therefore, in deciding upon legal structure to take into account the means for attracting new money.

In *single proprietorships*, the owner may raise additional money by borrowing, by purchasing on credit, and by investing additional amounts himself. Since he is personally liable for all the debts of his business, banks and suppliers will look carefully at his personal wealth. Consequently, the funds he can get will always be limited by his own circumstances. For this reason alone, a business requiring large amounts of capital for successful operation should probably not be organized as a single proprietorship.

Partnerships can often raise funds with greater ease, since the resources of all partners are combined in a single undertaking. Like single proprietors, partners must accept full personal liability for business debts; for this reason, a partnership may be able to borrow on better terms than some corporations. In addition, outsiders may be willing to extend credit because of the security deriving from the individual partners' full liability.

Corporations are usually in the best position of all to attract capital. They may, for example, acquire additional funds by borrowing money by pledging corporate assets. Also, they may sell securities to the public and attract a wide range of investors. A shareholder's investment in a corporation will not subject him to any financial risk beyond the amount of his holdings. In addition, as a part owner, he has the prospect of sharing directly, through dividends and rising value of the securities, in any profits the concern makes.

SMALL BUSINESS
ADMINISTRATION
U. S. Government Agency

Management
Research Summary

Choosing A Form Of Business Organization

By *Robert N. Davies* and *Kelvyn H. Lawrence*, Duke University, Durham, North Carolina

HIGHLIGHTS

Prudent selection of a form of business organization involves choosing not just from among the standard forms in their typical patterns, but from the forms as they can be tailored by skillful planning and drafting. Legal help is essential.

A decision as to the legal structure of a business is never final. As changes occur in a firm and in the financial and tax status of its owners, the question should be reexamined.

The idea that when businessmen form a corporation, all danger to their personal estates ceases is a mistaken one, according to the report.

The comparative tax burdens of the various business forms can be determined only by careful study of the individual firm and of the financial status of the owners.

Large business enterprises are, with few exceptions, conducted as corporations. But in small enterprises there is more opportunity for choice as to business form. The choice requires the weighing of complex legal and business considerations. It should be made only with the help of an attorney.

Also, according to the report summarized here, a decision as to business form is never final. As changes occur in a business and in the financial and tax status of its owners, the question of what business form is best should be reexamined.

KINDS OF ORGANIZATION

The principal types of legal structure for businesses are (1) sole proprietorship, (2) partnership, (3) limited partnership, (4) joint stock company, (5) Massachusetts or business trust, and (6) corporation. Single proprietorship, partnership, and corporation are the most frequently used.

Legal craftsmanship can often tailor one of these to the needs of the individual enterprise. Thus, prudent selection of a business form involves choosing not just from among the standard forms in their typical patterns, but from the forms as they can be fashioned by skillful planning and drafting.

• Sole Proprietorship

This is the simplest form in which a business can be conducted. The owner simply goes into business, with the business assets in his own name. State laws do not prescribe organization procedures. Nor is a sole proprietorship required, as corporations are, to register or qualify before doing business in other States.

• Partnership

In a partnership, the business is conducted by a number of persons who have

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AVAILABILITY OF THE FULL REPORT

Copies of the full report, titled "Choosing a Form of Business Organization," may be purchased for $4.00 from Small Business Studies, Duke Law School, Durham, North Carolina. Make checks payable to Duke University.

This report was prepared under the 1959 Small Business Management Research Grant Program of SBA. It may be reviewed at any SBA field office or at certain depository libraries whose addresses may be obtained from the SBA field offices or from the Small Business Administration, Washington D.C. - 20416.

equal status and authority as owners or principals. Setting up a partnership ordinarily involves contribution by the partners of property, money, credit, skill, or labor that will make up the capital or foundation of the business.

A written agreement (articles of partnership) spelling out the rights and duties of the partners is highly desirable; but no contract, either written or oral, is required. A partnership can be created simply by several persons conducting a business for profit as co-owners. When a written agreement is drawn up, the report states, it is a private document and need not be filed with a public agency.

Businessmen often think of a partnership as a business unit distinct from the partners as persons, and it is treated as a unit for accounting purposes. American law, however, generally does not regard the partnership as an entity but as a group of individuals.

Like the sole proprietorship, the partnership ordinarily may do business across State lines without registering or qualifying in any way.

• Limited Partnership

The limited partnership is a variation of the partnership. It permits persons contributing capital to the enterprise to avoid unlimited liability by becoming special, or "limited," partners.

This form of business organization is somewhat more difficult to set up. Procedures prescribed by law must be carefully followed.

One of these procedures is the filing of articles of limited partnership with a State official. This makes public the financing arrangements among the participants, together with certain other matters concerning the firm's internal affairs.

• Joint Stock Company

The joint stock company differs from a partnership in the following ways: (1) it is less likely to be seriously affected by the death or withdrawal of a participant; (2) it is governed by a central management group; and (3) it has freely transferable shares. The articles of association of a joint stock company, like articles of partnership, constitute a private contract that need not be filed with a public official.

• Massachusetts or Business Trust

In a Massachusetts, or business trust, (so called because the plan originated in Massachusetts) business assets are transferred to trustees to be managed for the profit of those who contribute capital. Formerly, some State securities laws and regulatory and tax measures to which corporations were subject did not apply to business trusts. These advantages have been largely done away with by statutory amendments extending the measures to business trusts.

Joint stock companies and business trusts generally are not required to qualify in order to do business in other States.

• Corporation

A corporation is recognized by law as having an existence apart from the owners (shareholders). In the adjustment of rights, duties, and other legal relations arising out of the enterprise, the corporation is treated as a distinct entity.

Incorporation papers setting forth certain basic information must be prepared and filed with designated public officials. The corporation's financial structure and management pattern must conform, in some degree, to standards set out in the corporation statute.

• The Closed Corporation

Some of the traditional features of the corporation--for example, free transferability of shares--are often not desired in a small business. Legal craftsmen have shown great skill in tailoring the corporate form to fit small closely held enterprises. In fact, they have virtually created a new form of business organization, the "close" or "closed" corporation.

LIMITED LIABILITY

Businessmen often incorporate an enterprise to limit their risk to the funds and assets they put into the business in payment for their shares. Under other types of legal business structure, greater responsibility for the firm's obligations rests on the participants as individuals.

A sole proprietor, for instance, is personally liable for all the obligations of his business. Similarly, in a partnership and a joint stock company, the participants are personally liable for claims against the firm. In a limited partnership, the special partners may have limited liability, but at least one participant must be a general partner and accept full liability.

A business trust can be set up in some States so as to achieve limited liability for investors who do not take part in managing the business. The trustees, however, are personally liable (1) on business contracts, unless absolved by a statute or by stipulation with the other contracting parties; and (2) for torts (negligent acts or other offenses) committed by trust agents in conducting the business.

Shareholders in a corporation are not, as a rule, responsible for the corporation's obligations. But the notion that when businessmen form a corporation, all danger to their personal estates ceases is a mistaken one. Statutes in a number of States, for instance, impose personal liability on shareholders for the corporation's unpaid wage claims. Furthermore, shareholders who are also directors and officers (as shareholders usually are in small businesses) may incur heavy liabilities in their capacities as directors and officers, even though they are shielded from liability as shareholders.

When a small corporation borrows money, the bank usually requires the principal shareholders to endorse the corporation's note or act as sureties on the loan. In other words, lenders often force shareholders to contract away part of their limited liability by assuming ultimate responsibility for the payment of large corporate obligations.

CONTINUITY OF EXISTENCE

Businessmen usually want to ensure that their enterprise will not have to be liquidated if an associate dies or withdraws. A participant's death, withdrawal, incapacity, or bankruptcy may have a serious effect on the continuity of a single proprietorship or general partnership.

As a rule, the effect is less serious in the case of a corporation, limited partnership, business trust, or joint stock company. Proper planning and drafting, however, can achieve a high degree of continuity even in sole proprietorships and partnerships.

For instance, a single proprietor can pass a going concern on to his wife or children by a carefully drafted will. Partners can specify in the articles of partnership or other agreement that if a partner withdraws or dies, the other partners will have the option (1) to dissolve and liquidate the partnership, or (2) to purchase the interest of the deceased or withdrawing partner (or to cause the firm to purchase it) at a fixed price or at a price to be determined by formula.

EASE OF FINANCING

A corporation can usually borrow money more easily than a business operating in one of the other forms. Further, when equity capital is needed, investors prefer the corporation's free transferability of shares and limited liability. A partnership can only acquire outside equity capital by bringing new partners into the business, and investors are often wary of becoming partners.

CONTROL AND MANAGEMENT

The sole proprietor is, of course, in almost complete control of his business, except to the extent that he surrenders control by contract (for example, to creditors or employees). In the partnership or joint stock company, participants may set up among themselves almost any management arrangements they wish.

The limited partnership is similarly flexible, except that if a "limited" partner takes an active part in the business, he loses his limited liability. In a business trust, also, there is great latitude in setting up the management pattern. But the beneficial owners (shareholders) lose their limited liability if they exercise excessive control over the trustees.

A few States prohibit any substantial departure from the traditional management pattern of corporations, and this pattern is often unsuited to the needs of small firms. Under most modern statutes, however, the corporate form can be tailored to fit almost any small enterprise.

IMPACT OF TAXATION

The comparative tax burdens of the various forms of business organization can be determined only by the most careful study of the individual business and of the financial status of its owners. The help of a tax attorney is essential.

- Tax Status of the Business Forms

Corporations are usually treated as taxable units separate and apart from their owners. Thus, the same income may in a sense be taxed twice. The corporation pays Federal and State income taxes on its income; and the shareholders in turn pay income taxes on their income, which includes dividends received from the corporation.

Joint stock companies and business trusts are also usually treated as tax entities. They are, in general, subject to the same tax rules as corporations.

On the other hand, the partnership is not a tax entity. Each partner's share of partnership income (whether distributed or not) is included in calculating his personal income tax; the partnership is treated as merely transmitting income to the individual partners.

Generally speaking, the sole proprietorship is taxed as if it were a one-man partnership. A limited partnership may be taxed as a partnership or as a corporation depending on (1) its management pattern, (2) whether ownership interests are transferable, and (3) whether it has continuity of existence.

- Subchapter S Corporations

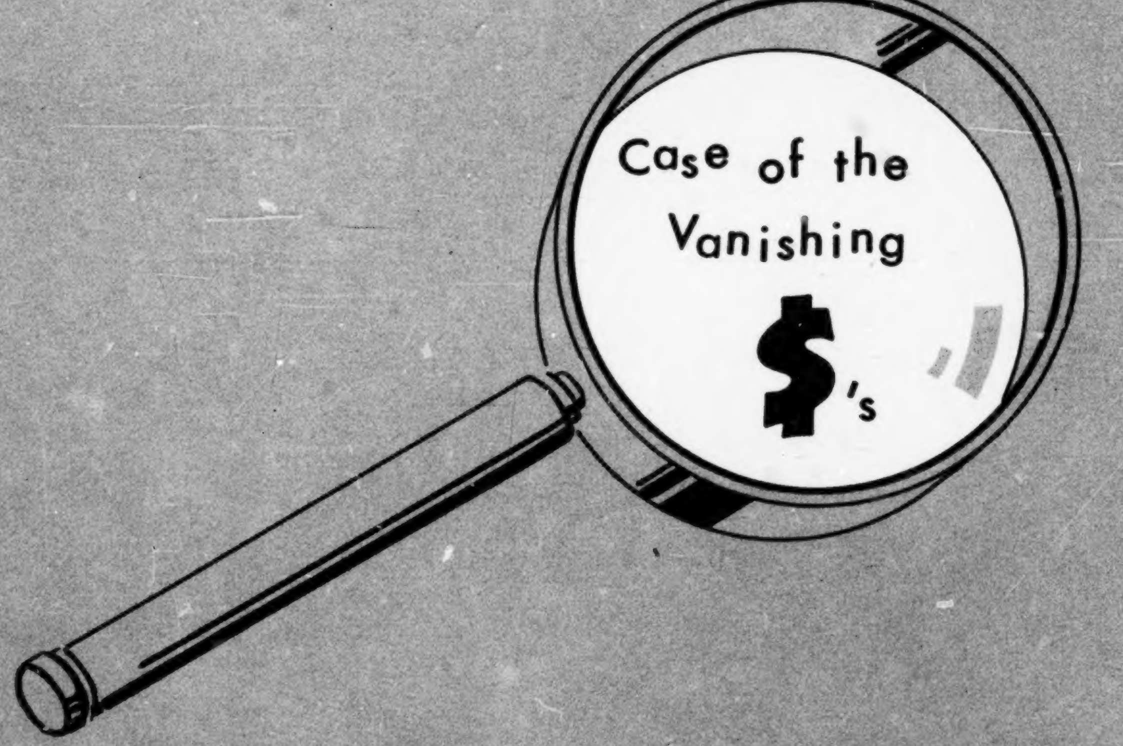
In 1958, Congress amended the Internal Revenue Code (by the addition of Subchapter S) to permit closely held corporations meeting certain requirements to bypass the Federal tax on corporation income. The income of the business is taxed to the shareholders directly.

Subchapter S provisions and the implementing rules are complex. They hold many traps for the unwary, according to the study. Thus, the existence of Subchapter S makes the help of a skilled tax attorney even more important in the selection of a business form.

ABOUT THE STUDY

This study is based on a combination of lawbook research and fieldwork. Small businessmen, lawyers, and other business advisors were asked (1) to list factors they considered important in selecting a form of business organization, and (2) to explain how they had gone about making a selection in specific situations. Information received was analyzed, and suggestions were carefully studied as to legality and practicability.

No specific recommendations are made in the full report as to form of organization, since no one form or combination of forms is suited to every small firm. But the study, as an aid to decision making in this area, discusses the advantages and disadvantages of the principal forms and their effect on various aspects of doing business.



CASES IN POINT

Case Studies for Depth Penetration

Section

The case method has proven stimulative and effective in many administrative management courses. The following case material is suggested as a means of encouraging discussion.

It is suggested that one full session be devoted to the presentation of the topic as outlined in this manual. A case can sometimes be used to stimulate or augment the discussion period that follows the presentation. This could be one way of expanding the basic materials into an advanced course on the subject.

THE CASE METHOD OF STUDY

The case method is a teaching device that helps the student learn through the processes of reasoning and decision making. Other popular teaching techniques stress learning or memorizing other people's knowledge on a given subject. The case method stresses his thinking abilities rather than his memory; it is dynamic, not passive.

What is a case? It is a description of an actual or true-to-life business situation. It is a statement of facts, opinions, and judgments—in short, a problem having no pat answer but lending itself to discussion and analysis.

The case method is particularly helpful in teaching businessmen because it uses real, practical problems rather than abstract situations. Properly used, it involves the participants in a way that will hold their interest and stimulate their thinking. It is particularly useful in developing in the individual (1) the ability to make decisions on administrative tasks (without incurring the penalties of a wrong decision on the job); and (2) the habit of thinking analytically and constructively.

The case method also highlights the value of group discussion and analysis. Each member of the group contributes from his unique experience, and each participant gains from the others. The group's knowledge and experience will exceed that of any one participant—including the instructor.

The following checklist can serve as a procedure for conducting case study and analysis:

Suggestions for Case Study

1. Read the case carefully for general content.
2. Arrange the facts of the case in order of importance.
3. Recognize and define the major problem(s) needing solution.
4. Analyze the problems and their relative importance.

5. Search for and establish alternative solutions.
6. Select the most desirable of the appropriate solutions.
7. Analyze your probable solutions; set up the pros and cons, giving value to each.
8. State your choice, decision, or final conclusion—and be prepared to defend it.
9. Set forth the plan or plans you would follow to implement the decision.

RELIANCE SPECIALTY CO.: PARTNERSHIP RESPONSIBILITIES

(A beginning mail-order specialty business encounters financial difficulties. Only one of the partners is in a sound financial position and consequently bears the entire loss.)

Pat Clement owned a small apparel store in a secondary retail district in Chicago. The business, operated as a sole proprietorship with three full-time employees in addition to Pat, was profitable and well established. Unneeded space in the back of the store had been blocked off and was not currently being used.

Gus Franklin, a longtime friend of Pat's, had been employed by a specialty mail-order house for 5 years when he suggested that he and Pat start a mail-order business of their own, to be called the Reliance Specialty Co. Pat had been considering expanding and had actually operated a branch store in a nearby district for 2 years. It was not profitable mainly because of inability to secure a reliable manager who would work without close supervision, and had been closed at the expiration of the 2-year lease.

Gus proposed that they start conservatively with about 40 well-selected items that his experience indicated were suitable to mail-order selling. All of these items were available from resources in the Chicago area, so it would not be necessary to carry heavy inventories at the start. The space in back of Pat's store would be ample for storage, packing, and the necessary paperwork. A postal substation was located just one block from the store, and using it would simplify both mail and parcel post shipments.

Pat and Gus had undertaken several informal teenager partnerships while attending the same school. Each man had ample basis for confidence in the ability and integrity of the other. Gus married fairly young, had a family, lived in a furnished apartment, and had only a few hundred dollars in savings. Pat was still a bachelor, lived in an apartment hotel, owned a popular-price car and his business, both free of debt. His combined personal and working capital checking account varied between $3,000 and $5,000. As yet he had not been in business for himself long enough to launch an investment program in addition to his store.

Without any partnership formalities beyond a verbal understanding that Pat would be reimbursed for his capital advances to the firm before a 50–50 profit-

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Adapted from Pearce C. Kelley, *Case Problems in Small Business Management*, 1952. Prentice-Hall, Inc., Englewood Cliffs, N.J.

sharing plan was undertaken, the enterprise was launched. Gus resigned from his position and devoted full time to the preparation of a catalog, compilation of a mailing list, and similar duties. He did an excellent job on the two projects stated, as well as in securing current price quotations from potential suppliers of the articles listed in the catalog. No effort was made, however, to obtain firm price commitments on any given quantity of goods or for any specified period of time. For several years preceding this, prices had been fairly stable with a slight tendency to decline.

Just as the last catalog was mailed, conditions changed and prices advanced under inflationary pressures. The Reliance Specialty Co. received orders that depleted their slim inventories within a week. At first the partners considered filling orders even at no profit to maintain the reputation of their company. Even this would not solve their problem, however, because it soon became evident many of their goods could no longer be obtained at prices permitting them a fair profit. Dissolution of the business was inevitable. Forms were quickly printed to accompany refunds on all future orders, and notices of dissolution were sent to the entire mailing list.

Pat paid the printer and all expenses connected with winding up the affairs of the company. His total loss was close to $3,500, half of which it was understood would sometime be repaid by Gus. Fortunately, Pat was able to settle the company's obligations without seriously impairing his own financial position or encroaching on his retail store business. The very change in economic conditions that forced the Reliance Specialty Co. out of business within 6 months enhanced Pat's profits from the store enough to compensate for most of the $3,500 loss. Gus soon had a job with a construction company. Both men learned a lesson about partnerships.

Questions

1. Since Gus was the mail-order expert, was it fair for Pat to suffer the entire financial loss? Discuss.

2. What would you have done had you been in Pat's position? In Gus's position? Explain.

3. Under the circumstances described in the case, should the Reliance Specialty Co. have been incorporated to begin with? If it had been, what effects would that have had on the outcome of the enterprise? Explain.

THE INCUBATOR

A How To Do It

Section

Experience has shown that people achieve maximum benefit from a conference, staff meeting, or training session when a period of incubation follows the implantation of the new idea, new information, or "new slant."

This is a do-it-yourself section that will allow the participants to try out or apply the ideas and information gained from this session.

This material may be reproduced locally for distribution to course participants.

INCUBATOR ASSIGNMENTS

Questions and Answers

Let's assume your retail business has expanded rapidly in the last few years and it has been suggested you incorporate your sole proprietorship. Under what conditions would you consider this a desirable course of action?

In what ways are sole proprietors of fundamental importance to our capitalistic system?

Can you offer an explanation why 95 percent of all businessmen are small-business men and most of them are sole proprietors?

You are approached by two successful partners in a service industry who convince you an investment in their business would pay handsome returns. State your terms for investing in this venture.

What does "unlimited liability" mean to you? Discuss its application under the three most common forms of business organziation.

As a creditor, would you rather own claims against a failing partnership or corporation (assuming both firms are about equal in size)? Why?

A good management team has "balance." Explain and discuss.

What ingredient necessary for success is provided under the better business franchises? Discuss.

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